MOSt Value

A Monthly newsletter on value investing

MAY 2007

From the desk of Raamdeo Agrawal

Dear Investor,

The new fiscal year started with unexpected strength and the Sensex has again crossed the 14,000 mark, giving more than 10% appreciation for the month. This is despite the huge concern about inflation and rising interest rate. The buoyant global equity markets and imminent turnaround in the inflation and interest rate could probably be the reasons for the markets to go up. Corporate earnings are robust and the initial indications are that the earnings will beat the expectations.

2006-07 was not a great year for portfolio performance though the Sensex went up by 15% and total market cap moved by about 10%. The participation in the market was restricted to few large-cap stocks like Reliance, Bharti, ICICI Bank and Infosys. The mid-cap segment remained lackluster except for few bright stocks like Indiabulls Financial Services, Aban Lloyd and Unitech.

In the backdrop of tight monetary policy and ambitious growth plan of the economy, it is likely that banks will have good business opportunities to borrow through their extensive branch network at reasonable costs and lend it at a good price. Old banks have large fixed overheads and advantage of newly acquired technological edge, giving them a very good spread on a larger asset base. At current valuation of 1.1/2x of book and about 5-6 P/E multiples, some of the public sector banks are good investment candidates. HDFC Bank, with 50% current and saving account deposit (CASA) and 100 new branches under its fold, is likely to do extremely well.

2007-08 should again be the year of strong corporate earnings growth and despite some de-rating of the valuation due to rise in short term interest rates, the market broadly should repeat the last year's performance.

Wishing you a Happy & Prosperous Investing!

Sincerely yours,

Raamdeo Agrawal

WEALTH CREATION THOUGHT

"Market demands conviction, as surely as, it victimises the unconvinced "

Model Portfolios

Select the portfolio that best suits your risk profile.

Scrip	MBP*	Wtg.*	%	First Reco. Date	First Reco. Price
AGGRESSIVE - HIGH RISK, HIGH RETURNS					
Apollo Tyres	319	H	8	Apr-05	280
Bharti Tele	837	H	7	Aug-03	48
EIH Associates	129	H	6	Jan-05	65
Nagarjuna Fertilizers	18	M	3	Dec-04	13
Rallis	332	M	3	Nov-04	120
Genus Overseas	249	H	8	Apr-06	210
Maha Seamless	558	M	5	Nov-06	420
Goldiam Int.	102	M	5	Nov-06	120
GMR infra	448	M	5	Mar-06	370
SAIL	135	M	5	Feb-06	117
Investment %			55		

Our Aggressive Portfolio works on the principle of 'no pain no gain'. The target returns are high at 30%+. Portfolio includes commodity, cyclical and small-cap stocks.

Scrip	MBP*	Wtg.*	%	First Reco. Date	First Reco. Price
MODERATE - MEDIUM RISK, MEDIUM RETURNS					
Bharti Tele	834	H	6	Aug-04	33
EIH Associates	129	H	9	Mar-03	11
Indian Oil	449	M	3	Dec-04	516
Nagarjuna Fertilizers	18	H	6	May-06	13
Rallis	332	M	4	Aug-05	206
Reliance Energy	512	L	5	Aug-03	48
SBI	1122	H	9	Jan-06	613
Raymond Limited	346	L	8	Dec-03	375
Pfizer Ltd	880	M	8	Feb-05	415
Era Constructions	397	M	8	Apr-06	170
Maruti	814	M	5	Sep-06	920
Navneet Publications	57	M	5	Dec-06	54
NIIT Tech	445	M	10	Feb-07	468
Satyam	479	M	5	Apr-07	445
Investment %			91		

Some moderation is achieved in this portfolio by investing in large and growth stocks available at value. The aim is to generate 20%+ annualized returns with less risk.

Scrip	MBP*	Wtg.*	%	First Reco. Date	First Reco. Price
DEFENSIVE - LOW RISK, LOW RETURNS					
Amtek Auto	392	H	5	Sep-05	235
Glaxo	1195	M	5	Mar-04	800
Hindusthan Lever	196	M	9	Dec-04	130
Indian Oil	449	M	5	Dec-03	375
Nestle Ltd	1071	M	7	Jan-05	935
SBI	1122	L	10	Nov-02	375
Union Bank	110	L	5	Dec-04	90
United Phos	330	L	12	Jan-05	140
Biocon	475	H	8	Apr-06	453
BEL	1742	M	5	Sep-06	1,141
Nicolas Piramal	256	M	5	Jan-06	254
Tata Steel	557	M	5	Jan-06	512
RCOM	472	M	7	Mar-06	390
Investment %			88		

Our Defensive Portfolio is exposed to very low capital erosion risk and yet could generate annualized returns of 15%+. Recommended for investors with low risk appetite, e.g. retired or aged individuals.

MBP* : Maximum Buying Price. One should not buy the stock if Price is above MBP.
Wtg.* : Weightage refers to the size of the position recommended. H-High, M-Medium, L-Low.

Last month's new recommendations of United Spirits and GMR Infrastructure have paid off well. We advise our investors to hold both these scrips for some more time to get the maximum gains out of them. However, fresh buying at current levels is not recommended.

In this issue, we recommend Amtek Auto and Nestle India. Amtek Auto is being recommended because the valuations have become very compelling, especially after the strong growth in topline and bottomline registered during the third quarter. Consolidated revenue grew 45.6% YoY to Rs10.8b in 3QFY07, while the consolidated adj. PAT grew 55.4% YoY to Rs1.1b.

Nestle's results for the first quarter have surprised most analysts with impressive growth of 27% and 22% in the topline and bottomline respectively, and this has been achieved despite severe cost pressure on raw materials like milk, milk powder and coffee. The scrip could be in for re-rating going forward.

We have taken profits in Welspun Gujarat, JSW Steel, Arvind Mills, Satnam Overseas, NIIT Ltd and ICICI Bank in the current period.

Our cash levels in the aggressive portfolio remain high at 45% because we think that in the extreme short term, markets may face some sort of downward pressure beyond levels of 14500. We remain invested to the tune of 91% and 88% in our moderate and defensive portfolios respectively.

Our aggressive, moderate and defensive portfolios returned 9.9%, 11.5%, 11.4% vis-à-vis 6.84% and 7.99% on the Sensex and Nifty respectively.

Additions or deletions of stocks are being communicated through our morning conference calls, MOSt Market Action emails or on 'AWACS' during market hours.

Sector	Allocation (%) Agg.	Mod.	Def.
Agrichem & fertilisers	6	10	12
Auto & Ancillaries		5	5
Banking		9	15
Cement			
Engineering			5
FMCG	0		16
Hotels	6	9	
Miscellaneous	18	5	
Oil & Gas		3	5
Pharma		8	18
Power		5	
Software		15	
Steel	5		5
Construction		8	
Pipes	5		
Textiles	0	8	
Telecommunication	7	6	7
Tyres	8		
Total	**55**	**91**	**88**

Amtek Auto

BUY : MBP - Rs400

YEAR END	NET SALES (Rs m)	PAT (Rs m)	EPS (Rs)	EPS GROWTH (%)	P/E (x)	P/BV (x)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
06/06A	27,711	2,565	15.8	73.9	24.4	2.9	15.7	10.2	2.0	11.1
06/07	40,438	4,045	24.9	57.7	15.5	2.3	19.9	15.8	1.3	7.2
06/08E	51,114	5,156	31.7	27.5	12.2	1.8	20.2	18.2	1.0	5.4

Background

Amtek Auto, the flagship company of the Amtek group, is the only player in India with a strong presence in both forgings and castings, along with commensurate machining capacity to supply finished components to global OEMs. It is a tier-I vendor to all the major OEMs in the domestic market such as Maruti, Hero Honda, Bajaj Auto, Hyundai and Tata Motors. It also supplies to global majors like Ford, BMW, GM, and John Deere through its subsidiaries in the US, UK and Germany. It has rapidly scaled up operations both through inorganic and organic growth, achieving scale, management depth and multi-country operations.

Auto component industry outlook remains positive

The auto component sector is witnessing strong demand from domestic OEMs, which have been ramping up their capacities in anticipation of sustained demand growth, and from global OEMs, which are offshoring components to reduce costs.

Superior technological capabilities

Acquisitions have given Amtek access to higher value added products and services like designing, complex machined components and assembly systems. The acquisition of Smith Jones, for instance, has strengthened its technological capabilities in ring gears - a critical auto component. As a result, Amtek's products like ring gears, connecting rods and crankshafts are considered to be of superior quality and are being supplied to global OEMs.

Integration of operations to yield significant synergies

To derive the benefits arising from synergies of consolidation, AAL is integrating its operations with those of its subsidiaries. Post integration, increased outsourcing from India by the acquired companies will be a significant driver of profits.

Another possible overseas acquisition

After the recent acquisition of a 20,000tpa aluminium foundry in Europe with revenue of ~US$100m, Amtek may make yet another acquisition. The company raised US$250m in FY07 and has cash reserves available, which may help the company to acquire bigger companies in the international markets.

Auto parts JV with Magna Powertrain

Amtek Auto signed a joint venture agreement in November2006 with Magna Powertrain, a division of the Canada-based $23bn Magna International. The 50:50 JV includes setting up a manufacturing facility in the Gurgaon-Daruhera belt for two-piece flexplate assemblies for automotive applications.

Manufacturing capacity is to be set up at the cost of Rs1b (Amtek Auto's contribution to be Rs500m). The facility will start operations late 2007. The joint venture will initially export flex plate assemblies to European markets, with production to follow for the Indian market. Flex plate assemblies are used in automobiles with automatic transmission systems.

Amtek India impresses

Amtek India's total revenue more than doubled to Rs2.7b, with a corresponding growth in profitability as PAT increased 117% to Rs376m.

The merger of Amtek India is still 18-24 months on the horizon, and is expected to happen only after Amtek Auto deploys cash surpluses in acquisitions and expansions, and completes integration of subsidiaries.

Valuation and view

Amtek is making conscious efforts to leverage the experience of acquired companies' key personnel to transform into a truly global ancillaries supplier. With the integration of the overseas companies acquired by Amtek, we believe there would be significant improvement both on the technological as well as the product quality fronts. We see robust growth in the company's consolidated revenue and profit, driven by a sharp rise in international revenue.

The stock trades at 15.5x FY07 consolidated EPS of Rs24.9, 12.2x FY08E EPS of Rs31.7, and 10.8x FY09E EPS of Rs36.

Nestle India

BUY : MBP - Rs1,050

YEAR END	NET SALES (Rs m)	PAT* (Rs m)	EPS (Rs)	EPS GROWTH (%)	P/E (x)	P/BV (x)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
12/06A	28,161	3,269	33.9	-0.6	31.6	17	53.8	79	3.6	18.9
12/07E	33,905	4,058	42.1	24.1	25.4	15.2	59.7	87.1	3	15.6
12/08E	38,580	4,749	49.3	17	21.7	13.7	63.1	92.3	2.6	13.3

Domestic revenue growth accelerates

Nestlé's net domestic revenue grew 24.3% YoY in 1QCY07, aided by lower excise due to increased production from the new culinary products facility at Uttrakhand. Net domestic revenue growth was backed by strong volume growth across product segments like noodles, chocolates and milk products. We are enthused by the good volume growth displayed by the company. Long term prospects appear encouraging due to low product penetration in the rural areas. The growing young population, rising middle class incomes and various lifestyle changes and aspirations present good growth opportunities for the company. We expect 20.5% and 14% growth in net domestic revenue to Rs30.5b in CY07 and Rs34.8b in CY08.

High commodity prices continue to drag gross margins

Nestlé's 1QCY07 gross margin declined from 54.9% to 52.7%, as the prices of key inputs like milk, wheat and vegetable oils increased sharply. However EBITDA margin increased 92bp to 20.7% in 1QCY07 due to decline in staff costs and overheads by 50bp and 180bp respectively. Prices of commodities like milk and wheat are expected to remain strong during the rest of CY07. We estimate that gross margins will decline by 80bp for CY07 and will remain flat for CY08 as Nestle has been slow to effect price increases in the past. Richer sales mix and selective price increases will prevent any substantial decline in gross margins, given the healthy volume growth in key categories.

Export revenues jump sharply

Export revenue jumped 69.3% YoY to Rs969m on a low base, driven by higher realizations from green coffee exports. The company has been reducing its dependency on exports of coffee to Russia and moving on to exports of new categories like milk, products and culinary products to newer geographies. We believe this is a step in the right direction. We expect 19.9% and 10.6% growth in gross export sales to Rs3.3b and Rs3.7b in CY07 and CY08 respectively.

New innovations to drive growth

Nestle has been relatively slow in innovations in the past few years. However, recently, the company has launched products such as Kit Kat Lite, Maggi Dal Atta Noodles, Slim Dahi, Everyday Slim, and Maggi Rice Mania. The products, which are positioned on the health platform of *Taste Bhi, Health Bhi,* offer excellent growth prospects due to increasing awareness towards health foods. Rising geographical spread of modern trade and cold chain can substantially accelerate the growth rates for food products in the coming years. We believe that such innovative products can catapult the growth rates to above mid teen levels; which the company enjoyed in the eighties and nineties.

Valuation and view

We believe the recent launch of innovative products like Maggi Rice Mania, Kit Kat Lite and slim versions of milk products have the potential to accelerate the growth momentum to the next level. We are bullish on the growth prospects in categories like noodles and chocolates and new milk products launched on the health platform. In our view, rising geographical spread of modern trade and cold chain will accelerate this growth further

We are revising our EPS estimates from Rs39.7 to Rs42.1 for CY07 and from Rs48.5 to Rs49.3 for CY08. The stock is trading at 25.4x CY07 and 21.7x CY08. Sustained topline growth of more than 15% can re-rate the stock, as the company has been slow in effecting price increases in the past.