kotak® Institutional Equities

INDIA DAILY

August 29, 2007

EQUITY MARKETS

India	28-Aug	1-day	1-mo	3-mo
		Change, %		
Sensex	14,919	0.5	(2.1)	2.8
Nifty	4,321	0.4	(2.8)	0.6
Global/Regional indices				
Dow Jones	13,042	(2.1)	(1.7)	(3.5)
Nasdaq Composite	2,501	(2.4)	(2.4)	(2.8)
FTSE	6,102	(1.9)	(1.8)	(7.6)
Nikkie	15,865	(2.6)	(8.2)	(10.2)
Hang Seng	22,875	(2.1)	1.3	11.7
KOSPI	1,805	(1.3)	(4.1)	8.6

Value traded - India

	28-Aug		1-mo	3-mo
			Moving avg, Rs bn	
Cash (NSE+BSE)	127.5		153.5	154.0
Derivatives (NSE)	570.2		657.8	393.0
Deri. open interest	860.6		726.0	672.0

Contents

Updates

Bharat Electronics: Company expects competition challenges arising from revised defense procurement policy

Canara Bank: To increase stake in Can Fin Homes; expect negligible impact

News Roundup

Corporate

- Two years after setting up an ambitious 50:50 joint venture to market farm produce, the Bharti-Rotschild combine is likely to rope in a third partner for FieldFresh Foods (P) Ltd. The likely partner is the US-based Del Monte Corporation, a large supplier to Wal-Mart Stores Inc., the world's largest retailer. Bharti and Wal-Mart recently signed an agreement for wholesale cash-and-carry operatons in India. *(BS)*
- US-based private equity fund Blackstone Group has inested US$150 mn to pick up a 12.5% stake in Hyderabad-based Nagarjuna Construction Company, the third-largest construction company in India. *(ET)*
- Indications are that the price formula put foward by Reliance (for the pricing of gas from Reliance Industries' KG basin) is likely to be broadly approved by the empowered group of ministers (EGoM) within the next couple of days. *(ET)*
- Essar Group said on Tuesday that it would be setting up a 1,200-MW plant at Jamnagar in Gujarat at an estimated cost of Rs480 mn. *(BL)*
- State-run PowerGrid Corporation of India hopes to raise a maximum of Rs298 million with an IPO of 0.57 mn shares. The offer will be priced in a band of Rs44-52 share. *(FE)*

Economic and political

- With the CPI (M) hardliners' rigid stand against the UPA government on the Indo-US civil nuclear deal issue, comrades in West Bengal seem to be in favour of a soft line, and are keen to see the Manmohan Singh ministry completing its term to ensure implementation of some major projects in the state. *(FE)*
- The much-awaited India-Asean Free Trade Agreement (FTA) was expected to be inked at the Asean Summit in November this year when the Prime Minsiters meet in Singapore, commerce secretary Gk Pillai said on Tuesday. *(BS)*
- Union Agriculture and Consumer Affairs Minister, Mr Sharad Pawar, said on Tuesday that States could not close down any establishment on a permanent basis unless there is violation of law. *(BL)*

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

Forex/money market

	28-Aug	1-day	1-mo	3-mo
		Change, basis points		
Rs/US$	41.2	-	66	68
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	8.0	-	6	(16)

Net investment (US$mn)

	24-Aug		MTD	CYTD
FIIs	103		(2,205)	8,030
MFs	84		723	461

Top movers -3mo basis

Best performers	28-Aug	1-day	1-mo	3-mo
		Change, %		
Reliance Energy	767	0.6	0.4	38.0
Chambal Fert	47	(0.7)	34.2	37.7
BHEL	1,807	(0.5)	8.8	26.5
Exide Indus	60	6.6	13.5	33.7
Thermax	611	0.9	(3.9)	30.3
Worst performers				
Escorts	82	3.3	(21.5)	(35.7)
Polaris	112	0.5	(8.8)	(32.5)
Balrampur Chini	55	3.7	(20.0)	(26.3)
Punjab Tractors	230	0.4	(14.1)	(26.9)
Raymond	257	0.1	(7.9)	(21.4)

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Industrials

BAJE.BO, Rs1713	
Rating	IL
Sector coverage view	Attractive
Target Price (Rs)	1,900
52W High -Low (Rs)	1950 - 1062
Market Cap (Rs bn)	137.0

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	40.5	48.5	56.9
Net Profit (Rs bn)	7.3	8.4	10.1
EPS (Rs)	91.7	105.7	126.0
EPS gth	*21.9*	*15.3*	*19.3*
P/E (x)	18.7	16.2	13.6
EV/EBITDA (x)	9.9	8.2	6.6
Div yield (%)	1.1	1.5	1.5

Shareholding, June 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	75.9	-	-
FIIs	9.3	0.2	(0.3)
MFs	7.9	1.0	0.5
UTI	-	-	(0.5)
LIC	1.5	0.2	(0.3)

Bharat Electronics : Company expects competition challenges arising from revised defense procurement policy

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- **Annual report highlights potential increase in competition led by implementation of Defense Procurement Procedure (DPP) 2006**
- **Several MOUs with foreign vendors, spurred by DPP**
- **We believe offset opportunity for BEL is unlikely to make up for increased competition ensuing from DPP 2006**
- **MOU target provides visibility on FY2008 revenues even though execution in the first quarter was lower than expected**
- **Revise earnings and target price to Rs1,900 (from Rs1,775 earlier), retain In-Line rating**

Bharat Electronics' management admits in its annual report that the introduction of an offset clause in defense procurement contracts above Rs3.0 bn and the freedom given to foreign vendors to align with any designated Indian company through DPP 2006 is likely to increase competition for Bharat Electronics. There has been brisk activity with several foreign vendors signing MOUs with BEL and 12 Indian companies are slated to get Raksha Udyog Ratna (RRU) status that would enable them to bid for defense contracts. We believe that offset opportunity for BEL may be modest, while DPP 2006 envisages significant loss of advantage as nominated canalizing agency for defense imports. Other observations from the annual report include (a) MOU to achieve a turnover of Rs47.25 bn which provides visibility to our FY2008 projections despite low 1Q execution (b) lower free cash flow generation in FY2007 (Rs5.3 bn versus Rs7.5 bn last year) compared to FY2006 because of increase in working capital requirements. We revise our consolidated earnings estimates for FY2008E to Rs106 from Rs103 earlier and FY2009E earnings estimate to Rs126 from Rs119 earlier based on (a) slightly lower (about 2%) revenue expectation versus earlier and (b) higher other income. Adjusted for cash and associated other income, Bharat Electronics is trading at 14X FY2009E earnings, about 35% discount to the industrials sector. We maintain our In-Line rating as we believe the discount is justified given low growth visibility.

Annual report highlights potential increase in competition led by Defense Procurement Procedure 2006

The management candidly admits in annual report that DPP 2006 is likely to increase competition for Bharat Electronics. Under the prevailing system, BEL was being nominated as the canalizing agency for supplies from foreign vendors with the responsibility of taking up indigenous manufacturing with mandatory transfer of technology (ToT) agreements. However, DPP 2006 introduces an offset clause in any defense procurement contract above Rs3.0 bn and provides foreign vendors with the freedom to align with any of the designated Indian companies (Raksha Udyog Ratnas) to meet the offset obligations (Exhibit 1). Previous system fostered inefficiency in procurement as DPSUs were the automatic canalizing agencies for imports and imbibing the technology and defense procurement had no role for the private sector.

Several MOUs with foreign vendors have been signed, likely spurred by DPP

BEL has signed MOUs with several global aerospace and defense vendors such as Lockheed Martin, Northrop Grumman, Boeing, European Aeronautics Defense and Space (EADS), CASA of Spain. BEL is also in discussions with several other companies for similar MOUs. We believe that these MOUs have been signed on the initiative of foreign vendors eyeing the Indian defense procurement market. As per DPP 2006, foreign vendors have to provide detailed plans, including listing the Indian partners with whom MOUs have been signed for meeting the offset obligations. The ability to meet offset obligations is one of the necessary prequalifications (checked through Technical offset offer) while detailed value and time break-up of meeting the obligations is specified in commercial offset offer that is discussed with L1 vendor at the time of award (Exhibit 2). However, only a minimum is required to be met and anything above that does not entail any preference in awarding the contract.

Offset opportunity for BEL is unlikely to make up for increased competition, several companies slated to get RRU status

We value the offset opportunity at about US$10 bn over the eleventh plan period and BEL may have annual revenues of about Rs6.1 bn from the offset opportunity during this period (equivalent to about 11% of FY2009E revenues) (Exhibit 3). However, this is unlikely to make up for increased competition from the private sector in defense procurement as a result of implementation of DPP 2006. As per news reports, Tata Motors, Larsen and Toubro, Tata Power Company, Mahendra and Mahendra, Godrej and Boyce, Bharat Forge, Infosys Technologies, Wipro Technologies and Tata Consultancy Services have been recommended for Raksha Udyog Ratna status in the first round. These companies can (a) get into indigenous defense production, (b) align with foreign vendors for supplying equipment to Indian Defense with technology transfer and (c) help foreign vendors meet their offset obligations by supplying them products, components and services.

Delays in implementing the DPP 2006, in designating the private sector companies, for instance, as RRUs would imply that competition for BEL would evolve later.

We believe changes in the defense procurement landscape would be gradual over a period of 5-10 years as the private sector builds capacity as well as capabilities to meet defense requirements and policy makers get more comfortable with private sector presence in this sector.

Procurement of Multi Role Combat Aircrafts (MRCAs) would be the test case

India is planning to procure 126 multi-role combat aircraft worth about US$10 bn. Several European and US vendors are vying for the contract and are already in touch with Indian vendors to strike JVs for meeting offset obligations. This procurement would be a test case of DPP and bring out clarity on the government thinking as well strategies of various vendors regarding offset obligations (Exhibit 4).

Significant shift in business mix potentially driven by large order from MTNL for convergent billing, exports do not pick up as expected

BEL's revenue mix has undergone a substantial change in the year FY2007 with the civilian sector contributing about 24% to the turnover versus about 13% in FY2006. We believe this shift in revenue mix has been led by execution of Rs5.0 bn order from MTNL for convergent billing system. We believe that the company had a target of US$24 mn worth of exports in FY2007 while the company has been able to achieve only about US $11 mn.

Operating cash flow generation declines with the increase in working capital

Free cash flows generated by BEL have reduced this year compared to FY2006 led by higher working capital requirements. Working capital requirements have increased probably because of (a) higher proportion of revenues coming in the fourth quarter, (b) project and product mix changes where BEL needed to invest in working capital as per the contract or tender conditions. We note that BEL works with negative working capital excluding cash (7 days of sales at the end of FY2007 versus 37 days at the end of FY2006). BEL generated free cash flow of Rs5.3 bn versus Rs7.5 bn in FY2006 and had cash balance of Rs20.9 bn (Rs261/share) at the end of FY2007.

MOU target provides visibility on FY2008E revenues even with very low execution in the first quarter

BEL has signed a performance MOU with the Ministry of Defense to achieve revenues of Rs47.25 bn in FY2008. We believe that this MOU provides visibility that BEL would be able to achieve our revenue estimate of Rs49.2 bn in FY2008 despite very low execution in the 1QFY08 (only about 8.6% of annual estimate versus about 12% in 1QFY06). BEL has consistently exceeded its MOU targets for the past nine years. Out of an order book of Rs91.3 bn outstanding at the end of FY2008 about 37 bn is executable in FY2008.

Revise earnings estimates and target price, retain In-Line rating

We revise our consolidated earnings estimates for FY2008E to Rs106 from Rs103 earlier and FY2009E earnings estimate to Rs126 from Rs119 earlier. Our earnings revision is based on (a) slightly lower (about 2%) revenue expectation versus earlier and (b) higher other income. We revise our DCF-based target price to Rs1,900/share from Rs1775 earlier (Exhibit 5). We highlight that BEL is currently trading at 13.6X FY2009E earnings while adjusted for cash and associated other income it is trading at 14X FY2009E earnings. We believe that about 35% discount to the sector multiple of 21.5 is justified based on (a) flat revenue visibility amidst rising visibility for the rest of the sector, (b) lack of publicly available data points / news flows to justify more optimism and c) infrequent investor communication and disclosures. We rate the stock In-Line and do not believe it is a compelling buy despite its cheap relative valuation. A key upside risks would be non-defense / overseas orders.

Exhibit 1. Various ways in which a vendor can meet offset obligations

1	Purchase of defense products and services	1. Purchase of defense products and components manufactured by Indian defense industry 2. Services include maintenance, upgradation, engineering, design, defense related software and quality assurance
2	Direct foreign investment	1. Direct foreign investment in Indian Defense industry through co-development, co-production etc.
3	Direct foreign investment in R&D	1. Direct foreign investment in Indian organisation engaged in defense R&D

Source: Defense Procurement Policy 2006, Kotak Institutional Equities

Exhibit 2. Format of Technical and Commercial offset offer to be submitted by foreign defense vendors

Format of Technical offset offer					
S No	Direct foreign investment, products and services	Indian Offset partner	% of offset obligation	MOU with Indian partner (if any)	Remarks
Format of commercial offset offer					
S No	Direct foreign investment, products and services	Indian Offset partner	Value	Timeframe for meeting offset obligations	Remarks

Source: Defense Procurement Policy 2006, Kotak Institutional Equities

Exhibit 3. Modest contribution for BEL from offset opportunity unlikely to make up for increased competition in defense procurement

Estimate of offset opportunity and ensuing upside for BEL during the eleventh plan period

	Rs bn	US$ bn
Total defense capex between FY2008-12	2,716	66.2
Foreign purchases with offset requirements (%)	50	
Contracs with offset obligations	1,358	33.1
Offset component (%)	30	
Offset opportunity	407	9.9
BEL's market share in offset opportunity	7.5	
BEL's revenues from offset opportunity during FY2008-12	30.6	0.7
Potential annual revenues from offset opportunity	6.1	0.1
As % of FY2009E revenues	**11**	

Source: Kotak Institutional Equities estimates

Exhibit 4. Contenders for procurement of 126 Multi Role Combat Aircrafts

Lockheed martin	F16
Boeing	F18
European consortium	Eurofighter
SAAB Sweden	Grippen
Dassault Aviation	Rafale
Russian	MIG 35

Source: Newsreports

Exhibit 5: DCF for BEL, March fiscal year ends 2008-2018E, (Rs mn)

	2007	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E
Revenues	40,485	48,469	55,739	64,100	73,715	84,772	93,249	102,574	112,832	124,115	136,526	150,179
Growth (%)	10.8	19.7	15.0	15.0	15.0	15.0	10.0	10.0	10.0	10.0	10.0	10.0
EBIT (excl finl income)	9,975	11,591	10,033	11,538	13,269	15,259	16,785	18,463	20,310	22,341	24,575	27,032
Growth (%)	19.9	16.2	(13.4)	15.0	15.0	15.0	10.0	10.0	10.0	10.0	10.0	10.0
EBIT Margins	25	24	18	18	18	18	18	18	18	18	18	18
Effective tax rate	31.7	31.7	31.7	31.7	31.7	31.7	31.7	31.7	31.7	31.7	31.7	31.7
EBIT*(1-tax rate)	**6,817**	**7,912**	**6,848**	**7,876**	**9,057**	**10,416**	**11,457**	**12,603**	**13,863**	**15,250**	**16,775**	**18,452**
Growth (%)	19.5	16.1	(13.4)	15.0	15.0	15.0	10.0	10.0	10.0	10.0	10.0	10.0
Depreciation / Amortisation	933	1,012	1,100	1,075	1,075	1,075	1,075	1,075	1,075	1,075	1,075	1,075
Change in Working Capital	(2,725)	227	(2,181)	(2,508)	(2,884)	(3,317)	(2,543)	(2,797)	(3,077)	(3,385)	(3,723)	(4,096)
Capital Expenditure	(1,013)	(1,000)	(850)	(1,200)	(1,200)	(1,200)	(1,200)	(1,200)	(1,200)	(1,200)	(1,200)	(1,200)
Free Cash Flows	**4,013**	**8,150**	**4,917**	**5,243**	**6,048**	**6,974**	**8,789**	**9,681**	**10,661**	**11,740**	**12,926**	**14,231**
Growth (%)	(38.2)	103.1	(39.7)	6.6	15.4	15.3	26.0	10.1	10.1	10.1	10.1	10.1
Years discounted		-	-	1	2	3	4	5	6	7	8	9
Discount factor		1.00	1.00	0.89	0.79	0.70	0.62	0.55	0.49	0.44	0.39	0.35
Discounted cash flow		**8,150**	**4,917**	**4,660**	**4,778**	**4,898**	**5,487**	**5,372**	**5,259**	**5,147**	**5,038**	**4,930**

WACC calculation			**Terminal value calculation**	
Risk-free rate (Rf)	6.00%	10-year G-Sec yield	Cash flow in terminal year	14,231
Beta (B)	1	2-year W. Beta against BSE 30	g	5.0%
Equity risk premium	6.50%		Capitalisation rate	7.5%
Expected market Return (Rm)	12.50%		Terminal value	189,750
Cost of Equity (Ke)	12.50%	Ke = Rf + B * (Rm-Rf)	Discount period (years)	8
Cost of Debt (Kd) (Post-tax)	8.00%	Estimated gross cost of debt	Discount factor	0.3897
WACC (Beta implied)	12.50%		Discounted value	73,954
WACC assumed	12.50%			

NPV calculation	**Rs mn**	**% of total**
Sum of free cash flow	53,707	36%
Terminal value	73,954	49%
Enterprise value	127,661	
Add Investments	-	
Net debt	(23,515)	16%
Net present value-equity	151,176	
Shares o/s	80	
NPV /share(Rs)	**1,890**	

Source: Company data, Kotak Institutional Equities estimates.

Canara Bank : To increase stake in Can Fin Homes; expect negligible impact

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- **Canara Bank makes an open offer to acquire 21.06% stake in Can Fin Homes Ltd**
- **Transaction will largely have an insignificant impact on Canara Bank financials**
- **Reiterate our IL rating on Canara Bank stock with a target price of Rs250**

Canara Bank has informed BSE that it plans to make an open offer to acquire an additional 21.06% stake in Can Fin Homes Ltd (Can Fin Homes)—currently the bank holds a 29.5% stake. Post this offer, Can Fin Homes will become a subsidiary of the bank. The offer price for the Can Fin Homes share has been fixed at Rs58. On successful completion of this open offer, Canara Bank would acquire 4.3 mn shares for a consideration of Rs249 mn. Can Fin Homes had a loan book of Rs19.4 bn as of March 2007 (close to 2% of Canara Bank's loan book). We believe this transaction will largely be inconsequential for Canara Bank. Reiterate our IL rating on the stock with a target price of Rs250.

Banking

CNBK.BO, Rs238	
Rating	IL
Sector coverage view	Neutral
Target Price (Rs)	250
52W High -Low (Rs)	320 - 174
Market Cap (Rs bn)	97.5

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	55.4	56.1	63.3
Net Profit (Rs bn)	14.2	12.5	15.3
EPS (Rs)	34.7	30.5	37.4
EPS gth	*5.8*	*(11.9)*	*22.6*
P/E (x)	6.9	7.8	6.4
P/B (x)	1.4	1.2	1.0
Div yield (%)	2.9	2.7	2.9

Shareholding, June 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	73.2	-	-
FIIs	17.5	0.3	(0.1)
MFs	2.4	0.2	(0.1)
UTI	-	-	(0.4)
LIC	-	-	(0.4)

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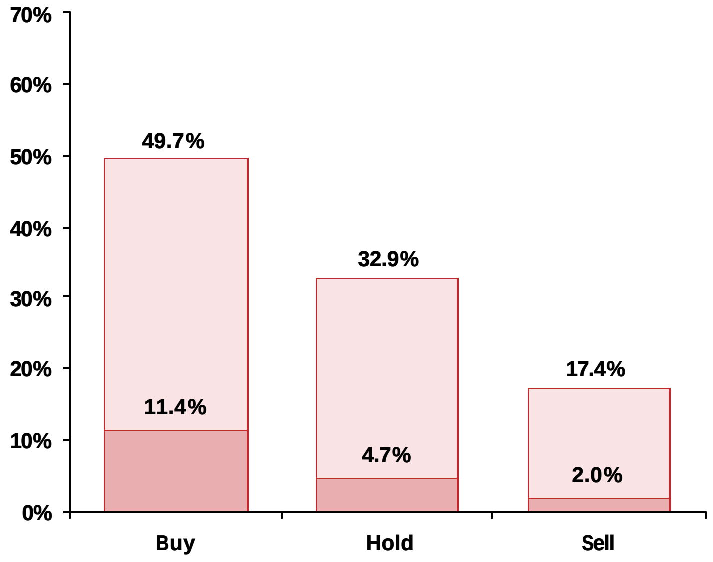

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Source: Kotak Institutional Equities. As of June 30, 2007

Ratings and other definitions/identifiers

Current 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.

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