Sharekhan top picks

In January 2009, the markets lost the bulk of their December 2008 gains amidst lacklustre quarterly performance (Sensex' earnings declined by about 10.6% in Q3FY2009) and deteriorating sentiments on the back of Satyam Computer Services (Satyam)' saga and increasing corporate governance concerns. During the month the benchmark indices, Sensex and Nifty, declined by about 7% each, while our portfolio of top picks marginally underperformed the broader markets, recording a negative return of 8% during the period.

This month, we are making four changes in our top picks portfolio. We have removed Aban Offshore from our list of top picks during the month on rising concerns about the deployment of its idle rigs, while we are also removing Shiv Vani Oil & Gas Exploration Services from our list. We are adding ICI India to our list in view of its appealing valuations and high cash levels, which can be used in the business to fuel growth. We are replacing Punjab National Bank with Bank of Baroda (BoB) on the back of its strong operational performance on all fronts and attractive valuations. Furthermore, we are also replacing Larsen & Toubro, in view of the uncertainties surrounding the Satyam acquisition issue, with Crompton Greaves.

Name	CMP* (Rs)	PER (x) FY08	PER (x) FY09E	PER (x) FY10E	RoE (%) FY08	RoE (%) FY09E	RoE (%) FY10E	Target price	Upside (%)
Bank of Baroda	247	6.3	4.9	4.5	15.8	18.0	17.4	316	27.8
Bharat Electronics	854	8.5	8.4	7.0	26.2	19.5	18.2	1,209	41.6
Bharat Heavy Electricals	1,366	23.9	22.1	15.7	25.9	23.0	25.8	1,546	13.2
Bharti Airtel	647	18.3	14.4	11.7	25.3	27.5	28.7	826	27.6
Crompton Greaves	131	11.8	9.1	7.5	31.5	29.9	27.5	210	60.9
Hindustan Unilever#	261	32.1	29.0	23.6	85.0	95.2	101.5	280	7.4
ICI India	390	20.8	11.3	9.8	8.8	14.8	13.6	493	26.4
ITC	183	22.1	20.8	17.7	27.7	25.5	25.4	206	12.8
Lupin	605	16.1	11.7	9.9	31.9	22.2	21.2	840	38.8
Marico	58	22	18.7	15.2	63.3	46.4	37.8	71	22.6
Reliance Industries	1,345	12.7	13.7	10.5	22.8	13.3	14.7	1,669	24.1
UltraTech Cement	416	5.1	5.6	6.3	37.4	26.2	19.3	475	14.2

* CMP as on February 06, 2009

#FY2009 earnings estimates annualised due to change of accounting year

<table>
<tr><th rowspan="2">Name</th><th>CMP</th><th colspan="3">PER</th><th colspan="3">RoE (%)</th><th>Target</th><th>Upside</th></tr>
<tr><th>(Rs)</th><th>FY08</th><th>FY09E</th><th>FY10E</th><th>FY08</th><th>FY09E</th><th>FY10E</th><th>price</th><th>(%)</th></tr>
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◆ BoB is among the top five banks in the country, with nearly 4% share of the deposits and advances of the domestic banking system. BoB has a large nationwide branch network of 2,899 branches and has 74 branches in 25 countries. Besides, the bank has a strong foothold globally as well.
◆ The bank has adopted a calibrated approach towards balance sheet expansion with a close eye on the profitability and the asset quality. The bank has grown its balance sheet at a CAGR of 25.9% between FY2006-FY2008, with its bottom line growing by a CAGR of 31.8% during the same period. We expect the bank to grow its balance sheet by a CAGR of 20.4% and its bottom line by a CAGR of 17.8% during FY2008-FY2010, in view of the anticipated moderation in the credit demand.
◆ The bank holds about 75% of its statutory liquidity requirement investments in the held to maturity category, which essentially provides significant cushion from the potential uptrend in the bond yields.
◆ In terms of asset quality, the key monitorable in the current environment, BoB is comfortably placed with the gross non-performing assets (GNPA) in percentage terms of 1.5% (vs our coverage average of 1.9%) for Q3FY2009. Moreover, the provisioning coverage of ~75% provides comfort in view of the anticipated deterioration in the asset quality at the industry level in the quarters to come.
◆ Though deterioration in the credit quality seems to be priced in, a steeper than currently expected downturn in Indian economy may lead to a surge in the delinquencies. This in turn would pressurise the profitability in the short term by the way of higher provisioning costs. However, from a long-term perspective, we believe that BoB will be able to maintain a delicate balance between growth, profitability and quality.
◆ At the current market price, the stock trades at 0.7x its FY2010E book value per share. The current sub-par valuation makes BoB an attractive investment, as we believe that the bank is well positioned to successfully navigate through the challenging times ahead.
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◆ Bharat Electronics Ltd (BEL), a public sector unit, has a market share of about 57% in the strategic electronics business. It is well poised to tap the huge opportunity in the defence sector.
◆ The company has an order backlog of Rs9,450 crore as on March-end 2008, which could drive the growth going forward. It would also benefit from over 27% increase in the capital outlay for the security and other equipment used by the defence forces.
◆ BEL is cash rich with an estimated cash per share of Rs398 and an attractive dividend yield of 3.6%.
◆ The quarterly performance fluctuates depending on the execution of orders with Q4 contributing 50% to the company's full-year performance.
◆ At the current market price, the stock trades at 8.4x its FY2009E and 7.0x its FY2010E earnings estimate.
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<tr><td>BHEL</td><td>1,366</td><td>23.9</td><td>22.1</td><td>15.7</td><td>25.9</td><td>23.0</td><td>25.8</td><td>1,546</td><td>13.2</td></tr>
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◆ Bharat Heavy Electricals Ltd (BHEL) is a premier manufacturer of power generation and is a leading EPC company. It has emerged as the prime beneficiary of the four-fold increase in the investments in the power sector in India.
◆ BHEL currently has orders worth Rs113,500 crore on hand, which provides revenue coverage for the next three to four years. With more than 85 % of the orders coming from the government and state utilities, the risk of order cancellation is minimal.
◆ The company would also be awarded four or five sets of 800MW supercritical technology based units from National Thermal Power Corporation (NTPC) on a negotiated basis. We believe the order inflow momentum would continue to remain strong for the company.
◆ At the beginning of 2008, the company brought on-stream 4GW of additional manufacturing capacity, taking its total capacity to 10GW per annum. In our view, the stabilisation of the new capacity coupled with the de-bottlenecking of the supply chain would aid BHEL's revenues to grow at a CAGR of 26.4% over FY2008-10E. However, the key challenge for BHEL would be the timely execution of projects.
◆ At the current market price, BHEL is discounting its FY2010 earnings by 15.7x, which we believe is attractive as the earnings of the company are expected to grow at a CAGR of 22.1% over FY2008-10E.
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Name	CMP	PER			RoE (%)			Target	Upside
	(Rs)	FY08	FY09E	FY10E	FY08	FY09E	FY10E	price	(%)
Bharti Airtel	**647**	18.3	14.4	11.7	25.3	27.5	28.7	**826**	27.6

Remarks:

- Bharti Airtel (Bharti) with over 24% market share is a leader in the Indian telecom space. On an average, the company has been adding more than 2 million subscribers every month and currently has a subscriber base of 85.7 million.
- Despite the competition-led pricing pressures, Bharti has been able to sustain its operating margins at 41-42% on the back of strong growth in subscribers.
- A less-than-expected fall in the average revenue per user should lead to a stronger operating performance. In the recent results, the company has reported an improvement in its revenue per minute after almost 12 quarters, which is an encouraging sign.
- With the entry of Reliance Communications in the GSM market, the competition is expected to increase, which could pressurise the margins. The uncertainty and aggressive bidding in 3G auctions are the risks, which could impact the cash flows of the company.
- At the current market price the stock trades at 14.4x FY2009 and 11.7x FY2010 estimated earnings.

Name	CMP	FY08	FY09E	FY10E	FY08	FY09E	FY10E	Target price	Upside (%)
Crompton Greaves	**131**	11.8	9.1	7.5	31.5	29.9	27.5	**210**	60.9

Remarks:

- Crompton Greaves Ltd (CGL) is one of the leading players in the country providing products and services in power system, industrial and consumer sectors.
- The acquisition of Pauwels and Ganz made CGL the seventh largest transformer manufacturer across the globe and helped it to plug gaps in its product and services offerings.
- Key initiatives by the government like Accelerated Power Development and Reforms Programme and Rajiv Gandhi Grameen Vidyutikaran Yojana spell good news for the sector and CGL being amongst the leaders should be the key beneficiary of the spending.
- The consolidated group's current order book of Rs6,592 crore provides revenue visibility for the next 10-12 months and with the order flows picking up from Power Grid Corporation of India we believe CGL should continue to maintain its order flow momentum.
- The key pressure points remain the slowing industrial capital expenditure and the slowing demand for distribution transformers due to housing slowdown.
- We estimate CGL's revenues and profits to grow at a CAGR of 20.7% and 25% respectively over FY2008-10E. At the current market price the stock trades at 9.1x its FY2009E consolidated earnings and 7.5x its FY2010E earnings.

Name	CMP	FY08	FY09E	FY10E	FY08	FY09E	FY10E	Target price	Upside (%)
Hindustan Unilever#	**261**	32.1	29.0	23.6	85.0	95.2	101.5	**280**	7.4

Remarks:

- Hindustan Unilever Ltd (HUL) is the largest fast moving consumer goods (FMCG) company in India, occupying ~20% of the Indian consumer space. With dominance across categories such as soaps, detergents, personal care products, food and beverages, it stamps its presence as an FMCG giant.
- With increasing per capita income fueling consumerism and up-gradation of lifestyle of the Indian consumer, HUL's revenues and profitability are expected to sustain the growth momentum.
- Further, a hefty free cash flow generation has led to huge cash reserves for HUL and rich dividends (dividend yield of ~3.6%) for its shareholders over the years.
- In the past four quarters the overall volume growth rate for HUL has been declining. Thus the lower volume growth is the key risk going forward, especially as in FY2010 the top line growth will be largely driven by volumes.
- A significant drop in the key raw material prices would help in improving the margins of the company in the coming quarters. Thus we believe the bottom line growth in FY2010 will be driven by better profit margins.
- At the current market price, the stock trades at 29x its CY2009E annualised earnings per share (EPS). We maintain our Buy recommendation on the stock.

Name	CMP (Rs)	PER FY08	PER FY09E	PER FY10E	RoE (%) FY08	RoE (%) FY09E	RoE (%) FY10E	Target price	Upside (%)
ICI India	**390**	20.8	11.3	9.8	8.8	14.8	13.6	**493**	26.4

Remarks:

- ICI India is a significant player in the Indian decorative paints market owned by Akzo Nobel, one of the global majors in paints. We believe with the backing of a strong parent the company is capable of sustaining handsome growth over the longer term.
- In the near term the paints business' sales volume is expected to remain under pressure due to slackening demand on account of slowdown in the real estate sector and repaint segment. Thus the sales growth is likely to be subdued.
- However, the sharp correction in crude oil prices and a consequential decline in crude derivative prices (key raw materials for ICI India) the margins are expected to improve significantly in the coming quarters and would drive the profitability in FY2010. Also, the ongoing buyback and cash per share of Rs260 on the books should help the company's shares to outperform its peers.
- At the current market price, the stock trades at 9.8x its FY2010E EPS while it trades at 5.5x its FY2010E earnings after adjusting for the cash. We maintain our Buy recommendation on the stock.

Name	CMP (Rs)	PER FY08	PER FY09E	PER FY10E	RoE (%) FY08	RoE (%) FY09E	RoE (%) FY10E	Target price	Upside (%)
ITC	**183**	22.1	20.8	17.7	27.7	25.5	25.4	**206**	12.8

Remarks:

- ITC's cigarette business that has dominance in the category continues to be a cash cow for the company. ITC has chalked out aggressive roadmap for making a mark in the Indian FMCG market with successful brands such as *Bingo*, *Sunfeast* and *Aashirwaad* already in the reckoning among the best in the industry. The company has further ventured into the personal care category with the launch of *Superia* and *Fiama Di Wills* soaps and shampoos that would compete with the likes of the products of HUL and Procter & Gamble.
- For the past two years the stupendous increase in the taxes on cigarettes has adversely impacted the volumes of the business. Thus in FY2010 we believe the government would be less lethal as far as further increase in the taxes is concerned. Nevertheless this remains a risk for the cigarette business of the company. Further, the sharp slowdown in the sales growth of the non-cigarette FMCG business does not augur well for the company especially as it is seen as a growth driver for the company. Hence its performance on this front needs to be monitored closely.
- We believe ITC has a well-diversified business model with multiple revenue drivers over the longer term, which would ensure sustained growth for the company. At the current market price, ITC trades at 17.7x its FY2010E earnings. We maintain our Buy recommendation on the stock.

Name	CMP (Rs)	PER FY08	PER FY09E	PER FY10E	RoE (%) FY08	RoE (%) FY09E	RoE (%) FY10E	Target price	Upside (%)
Lupin	**605**	16.1	11.7	9.9	31.9	22.2	21.2	**840**	38.8

Remarks:

- Global dominance in certain products, focus on niche less-commoditised products, a geographically diversified presence in newer markets such as Japan and a presence in the US branded segment distinguish Lupin among the mid-cap players in the generic space.
- With a leadership position in the anti-TB and other anti-infective segments, and growing exposure to the chronic therapy segments, Lupin is one of the fastest growing pharmaceutical companies in the domestic market.
- A focus on niche products like injectable cephalosporins along with presence in the branded space through a pediatric antibiotic, Suprax, has enabled Lupin's US business to grow at a staggering CAGR of 77% over FY2004-08.
- With a strong business in India and the USA, Lupin has also made inroads into the other regulated markets of the UK and France. Further, it has entered markets like Japan, Germany, Australia and South Africa through acquisitions in order to extend its global reach.
- Even though the core business remains strong, the US Food and Drug Administration issues relating to its Manindeep facility might remain a drag on the near-term performance of its stock.
- At 11.7x FY2009E and 9.9x FY2010E earnings, Lupin is among the cheapest front-line pharmaceutical stocks. We maintain our Buy recommendation on the stock with a price target of Rs840.

Name	CMP (Rs)	PER FY08	PER FY09E	PER FY10E	RoE (%) FY08	RoE (%) FY09E	RoE (%) FY10E	Target price	Upside (%)
Marico	**58**	22	18.7	15.2	63.3	46.4	37.8	**71**	22.6

Remarks:

- Marico is a major player in the Indian hair care and edible oil markets. Its flagship brand *Parachute* combined with *Nihar* commands a 55% share of the branded coconut oil market in India. Its good-for-heart edible oil brand *Saffola* is also witnessing good growth.
- Marico has been growing both organically and inorganically, and follows the strategy of adding new products and territories to its portfolio. Apart from domestic operations, its international business covers countries like Bangladesh, Egypt and South Africa.
- We believe apart from the growth in the existing business through product innovations, the expanding new age businesses of Kaya Clinics and weight loss centres promise a great deal.
- Decelerating volume growth in *Saffola* and slower same-store growth in Kaya are the near-term concerns for the company. However the prices of key raw materials, such as copra and Safflower, are likely to ease in the next few months, which would help in improving the margins and also help Marico to take price cut in key brands (especially *Saffola*) and boost the volumes.
- With a 21% earning growth expected in FY2010 it remains one of the better performing companies in the current tough macro scenario. At the current market price, the stock trades at an attractive valuation of 15.2x its FY2010E earnings.

Name	CMP (Rs)	PER FY08	PER FY09E	PER FY10E	RoE (%) FY08	RoE (%) FY09E	RoE (%) FY10E	Target price	Upside (%)
Reliance Industries	**1,345**	12.7	13.7	10.5	22.8	13.3	14.7	**1,669**	24.1

Remarks:

- With the start of crude oil production on September 17, 2008 and whith the gas production from the KG basin expected to commence by the end of February, Reliance Industries Ltd (RIL) holds a great promise in the E&P business. The E&P business is expected to add significantly to the company's earnings and cash flow from FY2010 onwards with majority of the earnings coming from the less volatile natural gas business. The gas production will begin in small tranches initially and is expected to reach 40 million standard cubic metres per day (mmscmd) in a few months and to 80mmscmd by the end of 2009. At present, the company's reserves are estimated at 9 billion barrels of oil equivalents.
- We expect the gross refining margin of RIL to contract in the near to medium term, as new refineries with total capacity of 1.5-2.0 million barrel per day (including Reliance Petroleum Ltd [RPL]) are expected to come on-stream in 2009 in the environment of weak demand. However, we expect RIL to fetch a premium over Singapore Complex' GRM due to its superior refinery complexity. The refining volumes would also double as RPL's refinery has become operational on December 25, 2008.
- We believe that the margin and the plant operating rates would remain low in the petrochemical business, as the prices of petrochemical products are likely to be remain low on the back of a weak demand outlook.
- Delay in KG D-6 gas production and adverse outcome of the court case with RPL and NTPC are the key risks to our estimates. Furthermore, the ambiguity related to likely change in the section 80IB could take away the benefit of the seven-year tax holiday from the gas production. Any further fall in the refining and petrochemical margins could result in deviation from our estimates.
- At the current market price, the stock is trading at 13.7x FY2009E and 10.5x FY2010E consolidated earnings. We maintain our Buy recommendation on the stock.

Name	CMP (Rs)	PER FY08	PER FY09E	PER FY10E	RoE (%) FY08	RoE (%) FY09E	RoE (%) FY10E	Target price	Upside (%)
UltraTech Cement	**416**	5.1	5.6	6.3	37.4	26.2	19.3	**475**	14.2

Remarks:

- UltraTech Cement (UltraTech) is among the leading cement companies in India and is likely to benefit due to its multi-region operation. The present installed capacity of the company is 19.5 million tonne, which is 9.5% of the total domestic market.
- UltraTech is likely to benefit from the capacity expansion and the investment in captive power plants. A 4.9-million-tonne capacity expansion in Andhra Pradesh and the savings accruing on account of new captive power plants will improve the cost efficiencies.
- Despite our expectation of subdued cement prices going forward, UltraTech's top line will grow at a CAGR of 11.7% over FY2008 to FY2010E.
- The demand of cement is lacklustre especially in the western region and the company has 56.4% of its total capacity in the region. So if the demand fails to pick up it may lead to adverse impact on the earnings of the company.
- Our estimates for FY2010 are based on softened coal prices, so any hike in coal prices will impact the profitability of the company (as the company imports 60% of its coal requirement).
- At the current market price, the stock trades at a price/earning of 5.6x its FY2009 estimates an enterprise value/tonne of $63 for FY2009, which is at 37% discount to its replacement cost.

The author doesn't hold any investment in any of the companies mentioned in the article.