investor's eye

Visit us at www.sharekhan.com | November 07, 2006

Index

- Sharekhan Special >> Banking Q2FY07 earnings review
- Stock Update >> Solectron Centum Electronics
- Stock Update >> Hyderabad Industries

Take Five

Scrip	Reco Date	Reco Price	CMP	Target
BEL	26-Sep-06	1,108	**1,118**	1,525
India Cements	28-Sep-06	220	**222**	315
ITC	12-Aug-04	69	**189**	220
SE Asia Marine	12-Oct-06	190	**182**	270
Solectron	08-Dec-03	99	**227**	315

Sharekhan Special

Banking Q2FY2007 earnings review

- After two relatively dull quarters, the latest quarterly results truly justified the run-up in the banking stock prices. The exuberance in the banking sector is based on the core fundamentals and improved visibility in the earnings of the sector, a glimpse of which we have seen during Q2FY2007.
- The net interest income (NII) witnessed a handsome growth, backed by a strong advances growth and the relatively stable net interest margins (NIMs). Higher growth in the fee income helped a commendable growth in the core operating profits.
- With the benchmark yields down almost 50 basis points from the quarter ended June 30, 2006, instead of a mark-to-market provisions charge that was seen in the previous couple of quarters, we saw most banks writing back excess provisions. This kept the overall provisions down and helped the robust growth in profits.
- Based on the improved visibility in the earnings for the banking sector, we have revised the earnings for certain banks. We feel that with the busy season ahead the banking sector is poised to see better times. Our top picks among the public sector banks remain Bank of India, Canara Bank and Punjab National Bank while in the private banking space UTI Bank is our preferred choice.

Handsome growth in NII

The NII for the public sector banks (PSBs) excluding State Bank of India (SBI) saw a strong 16.8% year-on-year (y-o-y) growth with Bank of India (BOI) reporting the highest growth in its NII at 46.8% year on year (yoy). Among the private banks the NII increased by a whopping 43.9% yoy ahead of our expectations of a growth of 37.4% yoy (adjustments done for ICICI Bank) with ICICI Bank reporting a commendable 47.4% y-o-y growth.

...backed by strong growth in advances

The deposit and advances growth remained robust as on September 30, 2006 on a y-o-y basis as well as on a sequential basis. However a clear trend has been emerging among PSBs. The PSBs that have gone in for selective credit and deposit growth have improved their margins compared with the ones that have seen rapid advances and deposit growth, but have also eroded their margins. For example, Bank of Baroda and Allahabad Bank, which have had the highest growth in the advances amongst all the PSBs (and also 1.5x the industry growth), have eroded their NIMs substantially.

... and stable to improving NIMs

The NIMs for Q2FY2007 show that barring the PSBs that have had a faster balance sheet growth all the banks have

Banks	Net interest income				Core operating profit				Net profit			
Rs (crore)	Q2FY07	Q2FY06	% yoy	% qoq	Q2FY07	Q2FY06	% yoy	% qoq	Q2FY07	Q2FY06	% yoy	% qoq
Allahabad Bank	389.9	367.6	6.1	-0.3	218.0	194.0	12.4	-1.2	210.0	168.0	24.8	63.8
Andhra Bank	330.9	288.6	14.7	-1.3	206.0	171.0	20.2	2.6	146.0	133.0	10.2	25.8
Bank of Baroda	890.8	781.8	13.9	1.0	545.0	381.0	43.1	-0.8	288.0	259.0	11.3	76.6
Bank of India	849.4	578.6	46.8	11.1	488.0	354.0	37.9	2.3	212.0	132.0	60.5	1.6
Canara Bank	981.1	806.7	21.6	3.5	605.0	573.0	5.6	2.7	362.0	307.0	18.0	89.5
Corporation Bank	316.7	306.5	3.3	-2.5	241.0	232.0	3.9	-1.2	127.0	106.0	20.3	-11.9
PNB	1,362.8	1,190.8	14.4	5.4	818.0	613.0	33.4	-8.9	505.0	422.0	19.7	37.4
UBI	627.5	602.3	4.2	-1.1	390.0	325.0	20.0	-2.3	194.0	61.1	217.8	16.4
Total - PSBs excl SBI	**5,749.0**	**4,922.8**	**16.8**	**3.2**	**3,511.0**	**2,843.0**	**23.5**	**-1.9**	**2,045.0**	**1,588.0**	**28.8**	**37.6**
SBI	3,898.7	3,608.0	8.1	0.4	2,465.0	1,736.0	42.0	-6.1	1,184.0	1,215.0	-2.5	48.3
HDFC Bank	845.6	612.1	38.1	3.4	643.0	459.0	40.1	4.2	263.0	200.0	31.7	9.9
ICICI Bank	1,577.0	1,069.5	47.4	6.9	1,326.0	804.0	64.9	16.0	755.0	580.0	30.2	21.8
UTI Bank	365.2	255.5	43.0	13.5	252.0	167.0	50.9	-5.6	142.0	109.0	30.2	17.8
Total - pvt banks	**2,787.8**	**1,937.1**	**43.9**	**6.6**	**2,221.0**	**1,430.0**	**55.3**	**9.6**	**1,160.0**	**980.0**	**30.5**	**18.4**

Source: Sharekhan research

NIMs - mixed outcome

Banks	H1FY07	H1FY06	yoy chg (in bps)	Q2FY07	Q2FY06	Q1FY07	yoy chg (in bps)	qoq chg (in bps)
Allahabad Bank	2.79	3.05	-26	2.60	3.07	3.01	-47	-41
Andhra Bank	3.81	3.68	13	3.91	3.55	3.72	36	19
Bank of Baroda	3.24	3.37	-13	3.08	3.40	3.39	-32	-31
Bank of India	2.95	2.57	38	3.06	2.63	2.91	43	15
Canara Bank	2.83	2.89	-6	2.82	2.83	2.79	-1	3
Corporation Bank	3.20	3.56	-36	2.98	3.65	3.42	-67	-44
PNB	4.16	4.00	16	4.22	3.99	4.10	23	12
UBI	2.85	3.11	-26	2.76	3.18	2.94	-42	-18
SBI	3.32	3.13	19	3.27	3.13	3.37	14	-10
HDFC Bank	4.00	4.00	-	4.00	4.00	4.00	-	-
ICICI Bank	2.50	2.40	10	2.50	2.40	2.50	10	-
UTI Bank	2.80	2.73	7	2.92	2.80	2.68	12	24

Source: Sharekhan research
Quarterly figures are calculated if not reported, half yearly numbers are as reported by the banks

shown a healthy expansion in the NIMs on a yoy as well as quarter-on-quarter (q-o-q) basis. The NIM expansion was limited to an extent for the following reasons.

- Many of the banks had taken high cost deposits during the liquidity crunch between December 2005 and June 2006.
- The yields on investments have been falling as high yielding investments are getting redeemed in favour of lower yielding ones. The redemption has been done partially to fund the strong advances growth.

We believe that as the high cost deposits get out of the system in this quarter and the impact of re-pricing of advances (as most banks have hiked lending rates) is felt fully, the NIMs will improve further.

Core operating profit reports robust growth

Driven by a strong growth in the NII coupled with the strong growth in the fee and other incomes (excluding the treasury income) the core operating profit growth for the PSBs excluding SBI witnessed a robust 23.5% y-o-y increase, marginally lower than our estimates of a 28.2% growth, with Bank of Baroda (BOB) reporting the highest growth in its core operating profit at 43.1% yoy. The fee income of the PSBs grew by a strong 10.5% yoy and 1.7% qoq.

The core operating profit of the private banks grew by a handsome 55.3% yoy as the strong growth in the NII was equally supported by a 50% yoy and a 6.7% q-o-q growth in the fee income. Among the private banks ICICI Bank reported a commendable 64.9% y-o-y growth in its core operating profit.

Strong upswing in profits

The PSBs excluding SBI reported a strong net profit growth of 28.8% yoy to Rs2,044.9 crore, slightly below our estimates of Rs2,103 crore. Bank of India reported an excellent set of numbers with a net profit growth of 60.5% yoy compared to our estimates of a growth of 52.5% yoy.

All three private sector banks—HDFC Bank, ICICI Bank and UTI Bank--reported a 30% plus y-o-y net profit growth, with ICICI Bank reporting a net profit growth at 30.2% yoy compared to our estimates of a 24.7% growth yoy.

Asset quality—no major surprises yet

The asset quality of the sector remains healthy; some banks have opted to utilise the write back in investment depreciation towards making higher non-performing asset (NPA) provisions.

Valuations and view—many of the banks see upgrades in earnings

Based on the improved visibility in the earnings for the banking sector, we have revised the earnings for certain banks. We feel that with the busy season ahead the banking sector is poised to see better times. Our top picks among the public sector banks remain Bank of India, Canara Bank and Punjab National Bank while in the private banking space UTI Bank is our preferred choice.

The Bankex has gained 38.9% during Q2FY2007 and 11.1% till date from the May 10, 2006 market highs. We believe that the run-up is commensurate with the improvement in the fundamentals and improved visibility in the earnings of the sector, a glimpse of which we have seen during Q2FY2007. We feel that with the busy season ahead, the banking sector is poised to see better times.

Banks Rs (crore)	Advances H1FY07	H1FY06	% yoy chng	Deposits H1FY07	H1FY06	% yoy chng
Allahabad Bank	35,581.0	24,131.0	47.4	54,006.0	43,700.0	23.6
Andhra Bank	23,600.0	19,153.0	23.2	32,513.0	29,869.0	8.9
Bank of Baroda	70,956.7	48,935.6	45.0	107,681.5	86,145.2	25.0
Bank of India	73,689.0	59,165.0	24.5	103,294.0	85,856.0	20.3
Canara Bank	82,571.0	65,139.0	26.8	122,121.0	102,736.0	18.9
Corporation Bank	28,004.0	20,226.0	38.5	38,017.0	29,761.0	27.7
PNB	82,340.0	63,868.0	28.9	128,415.0	109,414.0	17.4
UBI	61,444.0	47,498.0	29.4	78,528.0	68,673.0	14.4
SBI	288,840.0	238,351.0	21.2	392,615.0	380,052.0	3.3
HDFC Bank	49,326.0	36,764.0	34.2	63,447.0	45,446.0	39.6
ICICI Bank	155,403.0	107,071.0	45.1	189,499.0	120,452.0	57.3
UTI Bank	29,121.0	18,404.0	58.2	48,920.4	34,055.0	43.7

Source: Sharekhan research

Ratio of upgrades to downgrades at 8:1

	New EPS estimates (Rs)		Old EPS estimates (Rs)		% yoy change	
	FY2007E	FY2008E	FY2007E	FY2008E	FY2007E	FY2008E
Upgrades						
Allahabad Bank	15.7	21.8	14.6	21.8	7.4	0.0
Andhra Bank	11.3	13.3	10.7	13.3	5.8	0.0
Bank of India	18.8	22.2	15.5	18.0	21.4	23.2
Canara Bank	36.8	45.9	32.0	39.0	15.0	17.7
Corp Bank	36.7	46.5	35.1	43.1	4.6	7.9
HDFC Bank	36.1	47.9	35.9	47.0	0.5	1.9
PNB	56.1	70.7	51.8	65.2	8.4	8.4
UTI Bank	21.6	27.8	20.8	26.3	3.8	5.7
Downgrades						
Bank of Baroda	26.8	36.6	26.7	38.1	0.4	-3.8

Source: Sharekhan research

Valuation table

	Price	Price	PER (x)			P/BV (x)			P/PPP			RoE (%)		
	(Rs)	target	FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E
Allahabad Bank	89.7	106.0	5.7	5.7	4.1	1.1	1.0	0.8	5.7	5.7	4.1	21.3	17.9	21.4
Andhra Bank	92.2	109.0	9.2	8.2	6.9	1.5	1.4	1.2	5.8	5.0	4.1	19.0	17.9	18.9
BOB	270.6	327.0	12.0	10.1	7.7	1.3	1.2	1.0	4.9	4.2	3.5	11.2	11.9	14.1
BOI	177.1	185.0	12.3	9.4	8.0	1.7	1.5	1.3	5.1	4.0	3.5	14.8	17.2	17.7
Canara Bank	292.2	320.0	8.9	7.9	6.4	1.7	1.4	1.2	4.4	3.9	3.4	20.3	19.5	20.7
Corp Bank	397.2	425.0	12.8	10.8	8.5	1.7	1.5	1.3	5.4	5.0	4.2	13.8	14.7	16.4
PNB	519.7	600.0	11.4	9.3	7.4	1.7	1.5	1.3	5.2	4.8	4.2	16.4	17.5	19.0
SBI	1,126.3	**	13.4	12.6	9.9	2.1	1.9	1.6	5.2	5.0	4.5	17.1	16.0	17.7
UBI	132.3	150.0	9.9	7.3	5.9	1.5	1.3	1.1	4.2	3.6	3.1	15.8	18.8	20.0
HDFC Bank	1,000.8	1,080.0	35.7	27.7	21.3	5.9	5.1	4.2	15.2	11.0	8.5	17.6	19.2	21.1
ICICI Bank	773.1	**	27.1	21.0	17.5	3.1	2.8	2.5	14.5	10.8	8.8	13.6	14.7	16.1
UTI Bank	440.7	490.0	25.3	20.4	15.5	4.3	3.7	3.1	12.3	10.1	7.6	18.4	19.3	21.5

Note: ** under review

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

Solectron Centum Electronics

Emerging Star

Stock Update

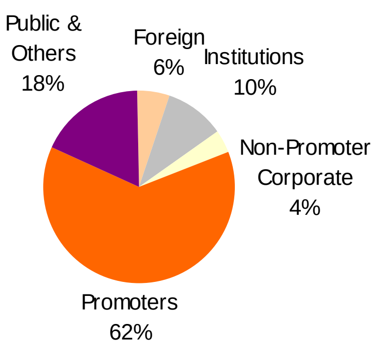
Unlocking value

Buy; CMP: Rs227

Company details

Price target:	Rs315
Market cap:	Rs337 cr
52 week high/low:	Rs340/127
NSE volume: (No of shares)	17,173
BSE code:	517544
NSE code:	SOLECTCENT
Sharekhan code:	SOLECTCENT
Free float: (No of shares)	0.56 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	16.3	35.7	-34.7	-6.2
Relative to Sensex	9.1	11.4	-39.5	-43.4

Result highlights

- Solectron Centum Electronics (SCEL) has reported a robust growth of 146.3% in its net revenues to Rs41.3 crore during the second quarter ended September 2006. The growth was largely driven by a 264.5% jump in the electronic manufacturing services (EMS) business to Rs32.4 crore. The component business grew by 12.7% to Rs8.9 crore.
- The operating profit margin (OPM) declined by 840 basis points to 11.5% due to the continued increase in the proportion of the low-margin EMS revenues in the total turnover. Moreover, the margins in the EMS business itself have been declining gradually (in line with the global benchmark decline of 5-6%).
- The robust jump of 363% in the other income component to Rs1.3 crore mitigated the impact of higher interest and depreciation charges. Consequently, the company posted a net profit growth of 51.2% to Rs3.6 crore. This is after including the provisions of Rs0.7 crore made for the proposed restructuring of the organisation.
- On the half yearly basis, the net revenues grew by 181.3% to Rs77.7 crore. However, the 810-basis-point decline in its OPM has limited the earnings growth to 31.5% (Rs6.8 crore).
- Along with the results, the company announced that its board has approved the scheme to de-merge the EMS business into a separate new company, Solectron EMS India Ltd (SEIL), which would be controlled directly by Solectron Corporation. On the other hand, the current management (the Indian promoter) would manage the component manufacturing business. The move is aimed at enhancing the focus on the two diverse business lines and is likely to be beneficial to the existing shareholders over the long term.
- At the current price the stock trades at 22.3x FY2007 and 20.5x FY2008 estimated earnings. We are upgrading the stock to a Buy recommendation with a revised price target of Rs315.

Result table Rs (cr)

Particulars	Q2FY07	Q2FY06	% yoy	H1FY07	H1FY06	% yoy
Net sales	41.3	16.8	146.3	77.7	27.6	181.3
Total expenditure	36.5	13.4	172.2	67.4	21.7	210.4
Operating profit	4.8	3.3	42.6	10.3	5.9	74.4
Interest	0.4	0.0	-	0.8	0.0	-
Depreciation	1.1	0.7	73.2	2.3	1.1	99.8
Other income	1.3	0.3	363.4	1.6	0.5	202.1
Extraordinary items	-0.7	0.0	-	-0.7	0.0	-
PBT	**3.8**	**3.0**	**28.0**	**8.2**	**5.3**	**54.3**
Tax	0.2	0.6	-66.0	1.4	0.1	938.8
PAT	**3.6**	**2.4**	**51.2**	**6.8**	**5.2**	**31.5**
Equity share capital	14.8	14.8		14.8	14.8	
EPS	2.4	1.6		4.6	3.5	
Margins (%)						
OPM	11.5	19.9		13.2	21.4	
NPM	8.4	13.9		8.6	18.4	

Segment-wise result analysis

The component business

The revenues from the component business grew by 12.7% to Rs8.9 crore. Though there have been signs of improvement in the last two quarters, the revenues from the component business remained stagnant in the range of Rs7-9 crore (as witnessed over the past 5-6 quarters).

In terms of the profitability, the profit before interest and tax (PBIT) margin continued to decline both on the yearly and sequential comparison basis. On the positive side, the expected commencement of the execution of the Rs35 crore pending order from ISRO should boost the revenues in the component business during the second half of FY2007.

Over the long term, the business is expected to improve with the revival of the demand from its erstwhile parent, C-MAC. Moreover, the growth in the EMS business of Solectron in particular (and of India in general) will also boost the demand for electronic components in the domestic market. Besides, the manufacturing facilities being set up or being expanded by the leading telecom equipment manufacturers like Nokia, Motorola, Ericsson and Siemens (totaling around $800 million of investment) in India is another factor that is likely to drive the demand for the company's component business.

The EMS business

The revenues from the EMS business grew exponentially to Rs32.4 crore in Q2FY2007, as compared to just Rs8.9 crore in Q2FY2006. The company continues to witness an encouraging ramp-up of the business from its existing clients like ABB, Visteon and Tejas Network. The operations of the third assembly line (that was set up in the latter half of Q4FY2006) have stabilised and contributed to the company's overall growth in revenues.

Segmental performance

(Rs cr)	Q2FY07	Q2FY06	% yoy
Sales			
- Components	8.9	7.9	12.7
- EMS	32.4	8.9	264.5
PBIT			
- Components	2.6	2.7	-2.7
- EMS	2.6	1.4	90.0
PBIT (%)			
- Components	29.3	33.9	
- EMS	8.0	15.3	

EMS business to be de-merged into a new company

The board has approved the scheme to de-merge the EMS business into a separate new company, SEIL. The details of the de-merger scheme are as under.

- SEIL would be controlled directly by Solectron Corporation. On the other hand, the current management would manage the component manufacturing business.
- As per the scheme, the Indian promoters would dilute their stake in SEIL whereas Solectron Corp would do the same in SCEL through a transfer of shares among the two promoter groups.
- The current equity share capital would be divided into two companies in a manner that the existing shareholders would receive one share each of the two new companies for every two equity shares held.
- The scheme would involve the cancellation of 74 lakh shares of SCEL.
- The share capital of both the companies would stand at Rs7.4 crore each.
- The restructuring is likely to get completed over the next 6-9 months after receiving approvals from the required authorities.

Rationale behind the move

The move would enable Solectron Corporation to focus on its key strength area of the EMS business, which has achieved the required scale of operations and would need considerable infusion of capital to maintain the growth momentum in the future. Moreover, the de-merger provides the required flexibility (to Solectron Corporation) to respond to the growing competition from the global EMS majors like Flextronics, Jabil Circuits, Foxconn etc, that have chalked out aggressive expansion plans in India.

Over the next few years, the EMS business is likely to grow exponentially in India. According to a study done by E&Y-MAIT, the global electronic contract manufacturing opportunity would grow to $500 billion in 2010 and India's share of it is estimated to be worth $11 billion (up from few hundred million dollars in CY2004). To tap this huge market potential, many leading global EMS players (such as Flextronics [Singapore], Jabil Circuit [USA], Foxconn [Taiwan] and Celestica [Canada]) are aggressively scaling up their operations in India to exploit the huge emerging opportunity. For instance, Flextronics is investing $200 million for setting up five million square feet of manufacturing facility near Chennai. The company is expected to manufacture over one million mobile phones per month from the Chennai plant by the beginning of the calendar year 2008. Flextronics aims to generate revenues of $1 billion from its Indian operations by 2009.

Beneficial to existing shareholders

We believe that the move would be beneficial for the shareholders over the long term. To begin with, the de-merger would provide enhanced focus on the two diverse business lines: component manufacturing and EMS. Under the direct control of Solectron Corporation, the growth in the EMS business is likely to receive a further boost given the fact that it is Solectron Corporation's core focus area globally.

Similarly, the Indian promoters have vast experience in component manufacturing that is likely to witness a robust demand in the light of increasing hardware manufacturing in India. Thus, the Indian promoters would be able to pay attention in scaling up the component business that has suffered over the past few quarters due to the efforts diverted towards scaling up the EMS business.

On the flip side, the restructuring exercise could impact the growth in earnings in the intermediate period. Moreover, the restructuring could result in one-time expenses (or write off).

Valuation

We have separately valued the component and EMS businesses to derive the fair value of the stock. The fair value of the component business (SCEL) works out to Rs151 based on the enterprise value (EV) of 10 times the estimated earnings before interest, tax, depreciation and amortisation (EBITDA) for FY2008. The EMS business (SEIL) is valued at Rs480 per share based on the anticipated market share (5% market share) of the total EMS opportunity worth $11 billion in India by 2010 (as per the MAIT-Ernst & Young report).

At the current price the stock trades at 22.3x FY2007 and 20.5x FY2008 estimated earnings. We are upgrading the stock to a Buy recommendation with a revised price target of Rs315.

Key financial

Particulars	FY2005	FY2006	FY2007E	FY2008E
Net sales (Rs cr)	42.2	83.3	158.3	199.3
Net profit (Rs cr)	12.9	9.9	14.2	16.4
Shares in issue (cr)	1.48	1.48	1.48	1.48
EPS (Rs)	8.7	6.7	9.6	11.1
% y-o-y growth	*55.0*	*-23.0*	*43.0*	*16.0*
PER (x)	26.0	34.0	23.7	20.5
Book value (Rs)	20.5	30.9	39.4	49.3
P/BV (Rs)	11.1	7.4	5.8	4.6
EV/EBIDTA (x)	26.3	20.5	11.9	9.5
Dividend yield (%)	0.7	-	0.9	1.1
RoCE (%)	39.3	29.7	34.7	34.0
RoNW (%)	44.5	26.1	27.3	25.0

Valuation of SCEL

Estimated EBITDA for FY2008 (Rs crore)	14.3
EV/EBITDA multiple	10.0
EV (Rs crore)	112.0
Less: Debt	0.0
Market cap (Rs crore)	112.0
Number of shares (cr)	0.7
Fair value (Rs per share)	151

Valuation of SEIL

Global contract manufacturing outsourcing by 2010 ($ billion)	500
Indian share of the opportunity ($ billion)	11
Solectron share (@5% of Indian market) ($ million)	550
EBITDA (@4% in $ million)	22
EV (EV/EBITDA multiple of 10)	220
Discounted EV (4 years @15%)	126
Less: debt	45
Market cap	81
Number of shares (mln)	7.4
Fair value ($ per share)	10.9
Fair value (Rs per share)	480
Fair value (average of SCEL and SEIL)	**315**

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

Hyderabad Industries

Apple Green

Stock Update

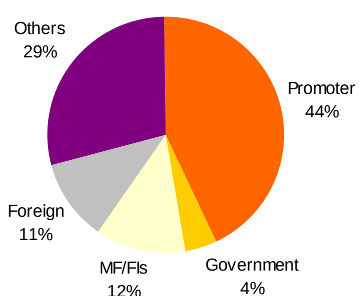
Results below expectations

Buy; CMP: Rs250

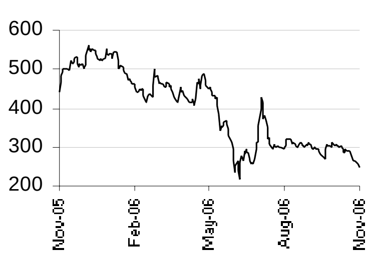
Company details

Price target:	Rs700
Market cap:	Rs179 cr
52 week high/low:	Rs577/215
NSE volume: (No of shares)	53,095
BSE code:	509675
NSE code:	HYDRBAIND
Sharekhan code:	HYDIND
Free float: (No of shares)	40.8 lakh

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-15.7	-13.3	-42.1	-40.9
Relative to Sensex	-20.9	-28.8	-46.4	-64.3

Result highlights

- Hyderabad Industries Ltd's (HIL) Q2FY2007 results are below our expectations. Lower-than-expected sales and higher raw material costs primarily affected the company's performance during the quarter.
- The net sales for the quarter rose by 15.4% to Rs101 crore. The sales were lower than estimates as the company faced rejection of products from its new Satharia plant due to certain quality issues.
- The operating margins have come down drastically from 17.6% to 3.2% due to the production problems faced at the new plant, and high ruling prices of cement, which is the key raw material. Consequently, the operating profits for the quarter declined by 79.2% to Rs3.2 crore. The raw material cost as a percentage of sales increased significantly from 45.1% to 56.3% in Q2FY2007.
- Higher depreciation costs due to the commissioning of its new plant at Satharia further impacted the profits as the net profit after extraordinary items for the quarter declined by 90.4% to Rs0.7 crore.
- At the current market price of Rs250, the stock is trading at very attractive valuations of 3.9x FY2008 earnings and 2.6x its FY2008 earnings before interest, depreciation, tax and amortisation (EBIDTA). We maintain our Buy recommendation on the stock with a price target of Rs700.

Slower top line growth due to lower off take from the new plant

HIL's net sales for Q2FY2007 rose by 15.4% year on year (yoy) to Rs101.0 crore. The sales for the quarter were lower-than-expectations even though its new plant at

Result table Rs (cr)

Particulars	Q2FY07	Q2FY06	% yoy	H1FY07	H1FY06	% yoy
Net sales	**101.0**	**87.5**	**15.4**	**224.2**	**219.3**	**2.2**
Total expenditure	97.8	72.1	**35.6**	200.2	178.2	**12.3**
Consumption of RM	64.0	45.9	39.5	119.1	95.0	25.4
Incr/decr in stock	-12.7	-14.2		-9.3	-5.9	
Employee expenses	9.8	9.3	4.6	18.8	21.2	-11.4
Selling & admn. exp.	12.7	10.8	18.0	26.3	24.5	7.4
Other expenses	24.0	20.3	18.1	45.2	43.4	4.2
Operating profits	**3.2**	**15.4**	**-79.2**	**24.1**	**41.2**	**-41.5**
Other income	0.6	0.9		2.3	1.8	
EBIDTA	3.8	16.3	-76.8	26.3	42.9	
Interest	0.7	0.8	-9.1	1.4	2.2	
PBDT	3.1	15.5	-80.2	25.0	40.7	-38.7
Depreciation	2.3	1.8		4.2	4.1	
PBT	0.8	13.7		20.8	36.6	
Tax	0.6	6.5		6.0	14.3	
Profit after tax	**0.2**	**7.3**	**-97.1**	**14.9**	**22.3**	**-33.5**
Extraordinary items	-0.5	0.0		3.9	-1.7	
Reported PAT	**0.7**	**7.3**	**-90.4**	**11.0**	**24.1**	**-54.5**
EPS (Rs)	0.3	10.1		19.8	29.8	
OPM (%)	3.2	17.6		10.7	18.8	

Satharia was operational from the current quarter. Frequent breakages, some product rejections faced due to certain quality issues coupled with higher competition restricted the top line growth. However, the quality problem was a temporary affair and the company has already taken steps to sort out the same. We gather that the volumes are picking up now and should improve further from December onwards.

Looking at the segmental results, the revenues from the building products division rose by 14.2% to Rs94.4 crore. Seasonally, Q2FY2007 is a lean period for the company due to the monsoons. Since Q3 is usually a strong quarter for the company, and with the quality problems from its new plant being sorted out, we expect the company to post a strong top line growth in Q3FY2007.

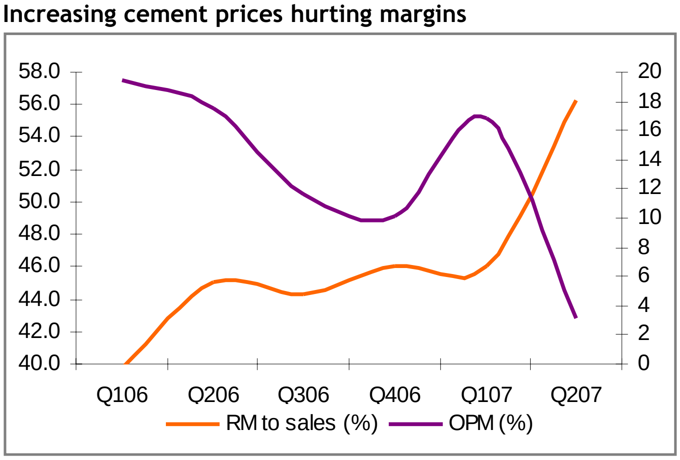
Segmental results

	Q2FY2007	Q2FY2006	% change
Revenues	100.95	87.63	15.2
Building products	94.37	82.63	14.2
Heavy engineering	1.23	0.43	186.0
Others	5.35	4.57	17.1
Profit/loss before interest and tax	3.2	15.9	-79.9
Building products	2.89	15.96	-81.9
Heavy engineering	-0.64	-1.02	-37.3
Others	0.95	0.96	-1.0

Rising cement prices impact the margins

The operating margins for Q2FY2007 declined significantly by 1,440 basis points to 3.2% as a consequence of the rise in the prices of cement, which is the primary raw material for its building products business. The raw material cost rose from 45.1% to 56.3% as a percentage of sales. As a result, the operating profit for the quarter marked a decline of 79.2% to Rs3.2 crore. On a segmental basis the profit before interest and tax (PBIT) margins for the building products division declined to 3.1% as against 19.3% in the corresponding period last year.

Increasing cement prices hurting margins



Increased automation and stabilisation of the new unit should help control the costs going forward. Increased competition and the capacity expansion undertaken by the other players in the industry has made it difficult for the company to increase its prices due to which it has not been able to pass on the increased costs of the raw material to the consumers. However, going forward, due to the rising prices of cement, we expect all the players to raise the prices in the coming months. Based on our channel checks, we expect the price to rise by 5-7% in mid-November and by another 3-4% towards the end of December.

HIL had paid off substantial debt in the last few quarters and as a result its interest cost has declined to Rs0.7 crore. However, the depreciation cost was higher due to the commissioning of its new plant. Consequently, the net profits for the quarter (after extraordinary items) have declined by 90.4% to Rs0.7 crore. In the first quarter the company had made a provision for the loss of Rs4.4 crore on a contract undertaken by the heavy engineering division (HED) division for Nuclear Power Corporation. During the current quarter the company has partly reversed that effect and hence extraordinary items include a recouped loss of Rs0.49 crore. Consequently, the net profits after extraordinaries have declined by 90.4% to Rs0.7 crore.

Capacity expansion plans to drive growth in FY2007

Looking at the strong demand for the asbestos cement sheets, the company is on an expansion drive. It has set up a greenfield sheet manufacturing facility in Satharia, which has commenced operations from July 2006, and the present manufacturing capacity is 652,000 metric tonne per annum (MTPA).

The company is further expanding its capacity by setting up two new sheeting plants with a capacity of 120,000MTPA each and a blocks plant during the year. One plant is expected to be operational by March 2007 while the second one will become operational by September 2007. The total capital expenditure for the same would be about Rs100 crore, and shall be financed through a mix of internal accruals and borrowings. With the completion of the expansion plans, the company aims to achieve a production of about 9 lakh tonne per annum. HIL is the market leader in the cement asbestos segment with a market share of 24%, which we expect will improve further once the capacity expansions are in place.

Valuation and view

The booming housing sector, capacity expansion plans, and the hiving off of the loss making engineering division would put the company on a high growth trajectory. Higher volumes from the added new capacities should help improve the margins going forward, but the margins are expected to remain under pressure due to the increased competition in the industry. At the current market price of Rs250, the stock is trading at very attractive valuations of 3.9x FY2008 earnings and 2.6x its FY2008 EBIDTA. We maintain our Buy recommendation on the stock with a price target of Rs700.

Earnings table

Particulars	FY05	FY06E	FY07E	FY08E
Net sales (Rs crore)	408.0	450.3	466.7	544.9
Net profits (Rs crore)	25.7	40.3	32.4	47.6
% y-o-y change		*286.8*	*-14.0*	*46.9*
EPS (Rs)	35.9	53.8	43.3	63.5
PER (x)	7.0	4.7	5.8	3.9
EV/EBIDTA (x)	5.6	3.1	4.2	2.6
ROCE (%)	21.2	34.3	24.1	29.5
RONW (%)	30.5	30.4	20.1	23.3

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

Sharekhan Stock Ideas

Evergreen

HDFC Bank
Infosys Technologies
Reliance Industries
Tata Consultancy Services

Apple Green

Aditya Birla Nuvo
ACC
Bajaj Auto
Balrampur Chini Mills
Bank of Baroda
Bank of India
Bharat Bijlee
Bharat Electronics
Bharat Heavy Electricals
Canara Bank
Corporation Bank
Crompton Greaves
Elder Pharmaceuticals
Grasim Industries
Hindustan Lever
Hyderabad Industries
ICICI Bank
Indian Hotels Company
ITC
Mahindra & Mahindra
Marico Industries
Maruti Udyog
Lupin
Nicholas Piramal India
Omax Autos
Ranbaxy Laboratories
Satyam Computer Services
SKF India
State Bank of India
Sundaram Clayton
Tata Motors
Tata Tea
Unichem Laboratories
Wipro

Cannonball

Allahabad Bank
Andhra Bank
Cipla
Gateway Distriparks
International Combustion (India)
JK Cement
Madras Cement
Shree Cement
Transport Corporation of India

Emerging Star

3i Infotech
Aban Offshore
Cadila Healthcare
KSB Pumps
Marksans Pharma
Navneet Publications (India)
New Delhi Television
Orchid Chemicals & Pharmaceuticals
ORG Informatics
Solectron Centum Electronics
Television Eighteen India
Thermax
TVS Motor Company
UTI Bank
Welspun Gujarat Stahl Rohren

Ugly Duckling

Ahmednagar Forgings
Ashok Leyland
BASF India
Deepak Fertilisers & Petrochemicals Corporation
Genus Overseas Electronics
HCL Technologies
ICI India
India Cements
Jaiprakash Associates
JM Financial
KEI Industries
NIIT Technologies
Punjab National Bank
Ratnamani Metals and Tubes
Sanghvi Movers
Saregama India
Selan Exploration Technology
South East Asia Marine Engineering & Construction
Subros
Sun Pharmaceutical Industries
Surya Pharmaceuticals
UltraTech Cement
Union Bank of India
Universal Cables
Wockhardt

Vulture's Pick

Esab India
Orient Paper and Industries
WS Industries India

Home