kotak® Institutional Equities

INDIA DAILY

November 19, 2007

EQUITY MARKETS

		Change, %		
India	16-Nov	1-day	1-mo	3-mo
Sensex	19,698	(0.4)	12.2	39.3
Nifty	5,907	(0.1)	13.3	43.8
Global/Regional indices				
Dow Jones	13,177	0.5	(2.6)	0.7
Nasdaq Composite	2,637	0.7	(3.2)	5.3
FTSE	6,291	(1.1)	(3.6)	3.7
Nikkie	15,198	0.3	(9.6)	(0.5)
Hang Seng	27,669	0.2	(6.1)	35.7
KOSPI	1,921	(0.3)	(2.5)	17.3

Value traded - India

			Moving avg, Rs bn	
	16-Nov		1-mo	3-mo
Cash (NSE+BSE)	275.0		298.9	235.7
Derivatives (NSE)	615.1		907.5	464.5
Deri. open interest	1,032.5		#####	869.5

Forex/money market

		Change, basis points		
	16-Nov	1-day	1-mo	3-mo
Rs/US$	39.3	-	(41)	(164)
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	7.9	-	(1)	(7)

Net investment (US$mn)

	15-Nov		MTD	CYTD
FIIs	195		(304)	16,245
MFs	123		(20)	158

Top movers -3mo basis

		Change, %		
Best performers	16-Nov	1-day	1-mo	3-mo
Neyveli Lignite	216	(0.1)	86.7	184.1
Reliance Energy	1,826	(1.5)	36.9	153.8
Reliance Cap	2,287	1.2	52.7	127.7
Engineers India	926	5.0	70.4	103.7
Chambal Fert	72	28.3	72.2	93.6
Worst performers				
i-Flex	1,415	0.4	(11.2)	(26.5)
Punjab Tractors	200	(3.1)	(7.9)	(19.1)
Infosys	1,624	(1.8)	(14.9)	(12.5)
Polaris	104	(0.4)	(7.4)	(10.6)
Essel Propack	53	(2.1)	(0.6)	(8.8)

Contents

New Release

Union Bank of India: Initiate coverage with a BUY rating

Banks/Financial Institutions: Asset quality likely to stay in fine fettle

Banks/Financial Institutions: Aggressive deposit rate cuts could improve profitability; drive stock price performance

Updates

Nestle India: Management exudes confident outlook

Cement: Moderate despatch growth in October, prices stable

Economy: RBI lays map for the introduction of FX futures—FIIs to be in soon, but PE funds are out

News Roundup

Corporate

- Private equity fund Capital Partners and a prominent Delhi-based industrialist are planning tp pick up 5-7% stake in Acme Telepower. (ET)
- Novo Nordisk, the Denmark-based pharmaceutical major, is betting big on insulin analogs as the Indian diabetes market follows a global shift towards this higher-priced variety from the human insulin version. (BS)
- Marks & Spencer (M&S) is planning to set up a 51:49 joint venture in the India. The move is part of a larger global business strategy of the British marquee retailer which is betting heavily on China and India for growth. (ET)

Economic and political

- The risk of a collision between the Federal Reserve and the markets grew after Fed governor Randall Kroszner made it clear that the US central bank was not planning to cut interest rates at its next policy meeting. (BS)
- The finance ministry wants to restrict investments by FIIs from countries whose market regulatory structure is not compliant with principles laid down by the International Organisation of Security Commissions (IOSCO). (ET)
- The petroleum ministry has asked the Comptroller and Auditor General of India (CAG) to conduct special audits of the oild an \d gas blocks awarded to companies under the pre-NELP and NEPL regime. This will be in addition to regular audits. (FE)

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

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Banking

UNBK.BO, Rs185	
Rating	BUY
Sector coverage view	Attractive
Target Price (Rs)	230
52W High -Low (Rs)	197 - 84
Market Cap (Rs bn)	93.6

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	36.3	41.5	45.7
Net Profit (Rs bn)	8.5	11.0	13.4
EPS (Rs)	16.7	21.7	26.4
EPS gth	*14.8*	*29.9*	*21.6*
P/E (x)	11.1	8.5	7.0
P/B (x)	1.8	1.6	1.3
Div yield (%)	1.9	2.6	3.1

Shareholding, September 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	55.4	-	-
FIIs	19.6	0.2	(0.0)
MFs	8.7	0.5	0.3
UTI	-	-	(0.2)
LIC	1.9	0.1	(0.1)

Union Bank of India: Initiate coverage with a BUY rating

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- **Expect Union Bank to deliver earnings growth of 20% between FY2008-FY2010 and sustain RoE of around 18-20%**
- **NIM likely at the bottom, operational performance to show an improvement on a sequential basis**
- **Initiate coverage with a BUY rating and target price of Rs230**

We find Union Bank valuations attractive and expect the bank to deliver healthy earnings growth and RoE over the next two years. The bank has significantly increased focus on training, technology implementation and risk management, all of which will likely translate into better performance going forward.

Key highlights

- Deposit growth far exceeding asset growth
- NIMs likely at bottom
- Asset quality under control
- Western and Northern India focus

Banking

Sector coverage view	Attractive

Company	Rating	Price, Rs 16-Nov	Target
SBI	ADD	2,326	2,000
HDFC	REDUCE	2,699	2,200
HDFC Bank	REDUCE	1,687	1,300
ICICI Bank	ADD	1,219	1,200
Corp Bk	BUY	450	470
BoB	BUY	389	375
PNB	BUY	603	620
OBC	REDUCE	268	240
Canara Bk	SELL	291	250
LIC Housing	ADD	358	345
Axis Bank	ADD	975	850
IOB	BUY	155	150
SREI	ADD	192	130
MMFSL	ADD	241	265
Andhra	BUY	102	120
IDFC	SELL	194	145
PFC	SELL	272	150
Centurion Banl	ADD	41	45
Federal Bank	REDUCE	475	410
J&K Bank	BUY	765	850
India Infoline	ADD	1,193	1,050
Indian Bank	REDUCE	168	145
Union Bank	BUY	185	230

Asset quality likely to stay in fine fettle

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- **Bottom up analysis of corporate financials provides comfort. Corporate sector is unlikely to be a major source of NPLs for the banking sector**
- **Macro environment remains favourable but we expect a moderate increase in corporate NPLs in FY2009 as the investment in capex is now leading to an increase in leverage in select sectors like infrastructure**
- **Analysis of retail sector assets is difficult given lack of sufficient data points. However, the recent slowdown in retail loans and fall in interest rates will likely reduce the risk in this segment**

The net NPL to GDP ratio for India has declined sharply to 1% in FY2007E from 10.4% in FY2002. A buoyant economy, lower D/E ratio, higher profitability and asset inflation is reflected in the strengthening balance sheet of the corporate sector and improving asset quality of the financial sector. However, the increase in interest rates will likely have an adverse impact on retail loans. A reversal in rates would therefore be positive. The macro environment remains favourable but we expect a moderate increase in corporate NPLs in FY2009 as the investment in capex is now leading to an increase in leverage in select sectors like infrastructure.

Bottom-up analysis on corporate loans provides comfort…

- Our bottom-up analysis of the corporate sector shows that the exposure to risky assets has fallen to 14% of loans in FY2007 from 32% of loans in FY2002.
- We expect an increase in the proportion of loans to risky assets to 19% in FY2009 as the leverage level in some sectors (like infrastructure) has been increasing. However, most companies have been effectively tapping the capital market to reduce their debt:equity ratios and we expect this trend to continue. The actual ratio could therefore be lower than our estimate.
- It is interesting to note that in FY2002, the proportion of risky assets was almost equally divided between small (sales <Rs1 bn), medium (Rs1-5 bn) and large industries (>Rs5 bn). However, this has changed substantially with the share of large companies in risky assets increasing to over 50%.
- Sectors considered risky are also changing. In FY2002, iron and steel, fertilizers, textiles, telecom and cement accounted for 55% of such loans. In FY2009, the composition will likely change to include the construction, engineering and diversified sectors.

…though retail is difficult to estimate

Over the past five years, retail loan growth has been strong at over 25%, with housing loans growing by 40%. The net household-debt-to-GDP ratio has thus increased to 5.4% in FY2007 from 1.3% in FY2000. Over the past two years, most banks have seen an increase in their NPL ratio in this segment. PSU banks saw higher NPLs likely due to inappropriate systems, while private banks suffered due to rising rates and small ticket loans. Given the lack of sufficient information, it is difficult to project retail NPLs, however, the recent slowdown in loan growth and fall in interest rates will likely reduce the risk in this segment.

Banking

Sector coverage view	Attractive

Company	Rating	Price, Rs 16-Nov	Target
SBI	ADD	2,326	2,000
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OBC	REDUCE	268	240
Canara Bk	SELL	291	250
LIC Housing	ADD	358	345
Axis Bank	ADD	975	850
IOB	BUY	155	150
SREI	ADD	192	130
MMFSL	ADD	241	265
Andhra	BUY	102	120
IDFC	SELL	194	145
PFC	SELL	272	150
Centurion Banl	ADD	41	45
Federal Bank	REDUCE	475	410
J&K Bank	BUY	765	850
India Infoline	ADD	1,193	1,050
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Union Bank	BUY	185	230

Aggressive deposit rate cuts could improve profitability; drive stock price performance

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- **Key takeaways of segmental analysis: (a) Retail segment RoAs to improve, (b)Non-retail segment RoAs likely to come off in FY2009, (c)Treasury segment likely to report losses in FY2008 and FY2009**
- **Banks would need to cut deposit rates to improve their margins**
- **Valuations remain attractive for the sector and deposit rate cuts could provide the trigger for stock price performance**
- **Downgrading Federal Bank to Reduce and initiating coverage on Union Bank with a Buy rating (target price of Rs230)**

Banking sector valuations remain attractive, however, banks need to cut deposit rates aggressively to improve RoAs. Our analysis shows an improvement in banking sector RoAs in the retail and treasury segment in FY2009, while non-retail RoAs could come off unless banks improve margins. We believe our earnings estimates and RoA projections for PSU banks carry upside risks from deposit rate cuts.

Valuations attractive, deposit rate cut may provide trigger. We advise selective stock picking on banking sector stocks given attractive valuations (1.4X to1.7X PBR FY2009) and downward pressure on rates. Credit growth will likely remain healthy at around 20-23%, and deposit growth at 18% in FY2009. Banks are unlikely to rush to reduce lending rates (RBI may hike CRR, raise MSS limit) though upward pressure has reduced and we believe there is scope for banks to further reduce deposit rates in order to improve margins. Rebalancing of overall assets i.e., reducing investments and increasing credit, could also help reduce margin pressure. We currently expect a fall in NIMs for banks in FY2008 and a bounce back in FY2009, though this will still be lower than FY2007. Our NIM estimate for FY2009 could carry upside risk if banks reduce deposit rates more than lending rates.

Highlights of our segmental analysis

- **Retail RoAs to improve.** Improvement in lending yields over the past 15-18 months in retail lending will likely lead to an increase in spreads and RoAs for banks in FY2008. We believe yields will fall in FY2009, but less compared to deposit costs and support RoAs. The retail segment will also likely benefit from lower standard asset provisioning, as substantial provisions were already made in FY2007.
- **Non-retail RoAs likely to come off in FY2009.** We expect an improvement in spreads and RoAs for the non-retail segment in FY2008, though a likely reduction in yields in FY2009—similar to that in deposit rates—may pressure margins and RoAs. This situation could arise due to a slowdown in credit demand. Despite higher spreads in retail, the non-retail segment continues to remain more profitable, likely because of higher fees and lower credit provisions.
- **Treasury likely to report losses for both years.** For the past two years, treasury has been the main drag on bank profitability—this trend will likely continue despite the fading risk of MTM hits. Key reasons for this are (1) zero interest yielding cash reserve ratio (CRR:7.5% of deposits), (2) falling tenures of investment books, (3) redemption of high yielding government securities from current portfolios and (4) mandatory requirements to invest in Gsec securities (25% of deposits, banks currently hold 33%) which provide lower yields than loans. Lower deposit rates and stable yields could reduce losses on treasury in FY2009.

Consumer Products

NEST.BO, Rs1371	
Rating	ADD
Sector coverage view	Neutral
Target Price (Rs)	1,400
52W High -Low (Rs)	1663 - 876
Market Cap (Rs bn)	132.2

Financials

December y/e	2006	2007E	2008E
Sales (Rs bn)	28.2	34.7	40.7
Net Profit (Rs bn)	3.3	4.3	5.4
EPS (Rs)	33.9	44.5	55.7
EPS gth	*(1)*	*31.3*	*25.2*
P/E (x)	40.4	30.8	24.6
EV/EBITDA (x)	23.6	18.5	15
Div yield (%)	1.9	2.0	2.5

Shareholding, September 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	61.8	-	-
FIIs	7.9	0.1	(0.2)
MFs	5.6	0.5	0.2
UTI	-	-	(0.3)
LIC	3.4	0.3	(0.0)

Nestle India: Management exudes confident outlook

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- **Confident outlook**
- **Defending margins—rising raw material costs**
- **Nestle categories have the pricing power**
- **Retain ADD rating**

In a meeting with analysts, Nestle's management indicated real internal growth of about 20% and volumes growth of about 15% contributing to achieve overall sales growth of 25% during the first nine months of CY2007. Price increases and positive benefits of operating leverage helped EBIT margins expand by 110 bps despite higher material costs. We believe Nestle still has huge opportunities for implementing cost-benefit programs and economies of scale to contribute to margins in a raw material cost inflation scenario. We estimate that the company can add 2-3% incremental topline growth by increasing its distribution reach over the next 4-5 years. We note that consumption potential in the categories in which Nestle operates gives it a favorable pricing power. We retain ADD rating and target price of Rs1,400/share.

Confident outlook. We came back impressed with the confident outlook and the management's confidence regarding the medium-term growth. The key takeaways include:

- Opportunity in the top-end of the consumer pyramid more than ever. Nestle plans to use the nutrition and wellness platforms to gain visibility and capture the prospects.
- Organizational restructuring undertaken in the past 2-3 years is now yielding benefits. The 'profit center' approach for each of the four business verticals with a separate General Manager and profit center Finance Manager / Controller as well as dedicated research resources.
- Positive impact of income tax benefit from Pantnagar unit to accrue from CY2008. We have already built in the impact of incremental Maggi volumes from this unit. Key upside to our assumptions include higher-than-expected insourcing and capacity expansion at this unit.
- Huge opportunity for penetration and consumption driven growth in coffee—the category currently has 28% penetration (we est. its annual penetration) and over three-fourth of consumers drink less than 1 cup in a week.
- We believe Nestle is ideally poised to (1) benefit from continued buoyant economic conditions with a strong portfolio and (2) derive distribution-led growth, particularly in semi-urban and rural areas. We estimate that the company can add 2-3% incremental topline growth per annum by increasing its distribution reach over the next 4-5 years. The key risk to our hypothesis is underinvestment in variable infrastructure for geographical expansion.

Defending margins—rising raw material costs. Prices for all the key raw materials—skimmed milk powder (SMP), wheat, green coffee, fats is up by 10-35% yoy during Jan-Sep 2007. Sugar is the only 'sweet' commodity for the company with a 24% yoy softening of prices. The prices of SMP have started moving up again after the lifting of ban on exports. However, we believe the company has a strategic buildup of raw materials (SMP and wheat) to protect margin erosion in the near term. Nestle had inventory of Rs3.4 bn as of Sept 30, 2007, much higher as compared to inventory of Rs2.3 bn on Sept 30, 2006. The ability to take price increases and cost control measures will keep the company's margins intact on a sustained basis as well, in our view.

Nestle categories have the pricing power. The company's volumes jumped about 15% and price realizations, including price hikes, registered over 10% growth in Jan-Sep 2007. We estimate the company has instituted over 10% blended price increases with certain categories like infant foods witnessing the maximum traction w.r.t. price increases at over 15%. Export volume growth was modest at about 2%. Reasons for the slowdown include—reduction in beverage exports to the USA, appreciation of Indian Rupee and restriction on export of certain milk-based products. However, exports value growth was better at about 16% indicating mix improvement. We like the innovation capabilities of the company (e.g., launch of probiotic yoghurts) and the multiple growth drivers, which it possesses. We expect Nestle to continue to wield considerable pricing power to pass on cost inflation. We note that propensity for consumption in the categories Nestle operates in is favorable given the pricing power.

Advertising and promotion expenses were maintained at about 7% of attributable product sales. We note that this is the lowest in industry against an industry average of about 12%. We attribute this to the relatively favorable competitive scenario to many of Nestlé's products. For example, Maggi noodles and Milkmaid don't have any meaningful competition at the market place. The key challenge for the company is to drive consumption in product categories where its brand is the leading category.

Drawing benefits of GLOBe implementation in 2005. Management indicated that the benefits of increased efficiencies and savings post the successful implementation of GLOBe project has started showing up in the current year. Through GLOBe, Nestle has standardized the internal processes and harmonized with Nestlé's best practices around the world.

Nestle-Financial performance, December yearends (Rs mn)

		yoy			yoy		
	3Q 2007	3Q 2006	% chg	9m 2007	9m 2006	% chg	2007E
Net sales	**9,067**	**7,227**	**25.5**	**26,087**	**20,798**	**25.4**	**34,748**
Material cost	(4,329)	(3,402)		(12,458)	(9,594)		
Employee cost	(693)	(539)		(2,036)	(1,592)		
Other overheads	(2,130)	(1,861)		(6,256)	(5,539)		
Total expense	(7,152)	(5,802)		(20,749)	(16,726)		
EBITDA	**1,916**	**1,425**	**34.5**	**5,338**	**4,072**	**31.1**	**6,941**
Depreciation	(184)	(168)		(542)	(486)		(733)
EBIT	1,731	1,257		4,796	3,586		6,208
Other income	57	47		158	141		205
Net interest	(1)	(0)		(6)	(3)		(11)
PBT	**1,787**	**1,303**	**37.2**	**4,948**	**3,724**	**32.8**	**6,402**
Tax	(597)	(431)		(1,667)	(1,351)		(2,111)
PAT	**1,190**	**872**	**36.5**	**3,281**	**2,373**	**38.2**	**4,290**
Extraordinary Income (loss)	(29)	(42)		(59)	153		-
Net profit	**1,161**	**830**	**39.9**	**3,222**	**2,526**	**27.5**	**4,290**
EBITDA margin (%)	21.1	19.7		20.5	19.6		20.0
Effective tax rate (%)	33.4	33.1		33.7	36.3		33.0

Source: Company data, Kotak Institutional Equities estimates.

Domestic sales growth far exceeds the exports sales gowth
Topline performance (9-months CY2007)

	Volume ('000 tons)			Value (Rs bn)		
	Jan - Sep 2007	Jan - Sep 2006	Growth %	Jan - Sep 2007	Jan - Sep 2006	Growth %
Domestic	187	162	15.5	24.8	19.7	25.9
Exports	13	12	2.4	2.4	2.1	16.1
Total sales	**200**	**175**	**14.5**	**27.2**	**21.8**	**25.0**

Source: Company data.

Strong value growth across categories
Divisional performance (9-months CY2007)

	Volume ('000 tons)			Value (Rs bn)		
	Jan - Sep 2007	Jan - Sep 2006	Growth %	Jan - Sep 2007	Jan - Sep 2006	Growth %
Milk products & nutrition	82	78	4.9	11.8	9.7	21.6
Beverages	18	17	8.5	5.2	4.3	20.9
Prepared dishes & cooking aids	73	57	27.9	5.8	4.4	31.8
Chocolate & confectionary	27	23	18.8	4.3	3.4	26.5
Total sales	**200**	**175**	**14.5**	**27.1**	**21.8**	**24.3**

Source: Company data.

Divisional performance (9-months CY2007)

	Volume growth %	Value growth %	Our estimates regarding growth drivers
Milk products & nutrition	4.9	21.6	Price hikes well ahead of cost inflation (highest impact in this category)
			Aggressive price hikes in Infant nutrition
Beverages	8.5	20.9	Portfolio rationalisation
			Underlying volume growth of about 12%
Prepared dishes & cooking aids	27.9	31.8	Product mix improvement
			Pack rationalisation (defocus on low profitability SKUs)
			Aggressive price hikes in Maggi brand
Chocolate & confectionary	18.8	26.5	Effective price hikes through grammage reductions
Total sales	**14.5**	**24.3**	

Source: Company data, Kotak Institutional Equities estimates.

Cement

Sector coverage view	Cautious

		Price, Rs	
Company	**Rating**	**16-Nov**	**Target**
Gujarat Ambuj	REDUCE	147	130
ACC	SELL	1,040	900
Grasim	ADD	3,831	3,400
India Cements	REDUCE	291	270
UltraTech Cem	SELL	1,002	850
Shree Cement	ADD	1,397	1,600

Moderate despatch growth in October, prices stable

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- **Despatch growth of 9% yoy in October 2007**
- **All India average cement prices stable at Rs231/bag—improvement in North India only**
- **We retain Cautious view on the sector**

Despatch growth of 9% yoy in October 2007. Cement despatches recorded a moderate growth of 9% yoy in October 2007. The YTD growth for the industry now stands at 8.9% against our estimate of 10% for FY2008. Despatches for the month have picked up (12.7 mn tonnes in September 2007) in line with our expectations as construction activity has picked up post the monsoon season. Strong despatch growth for Shree Cements is reflective of the capacity additions by the company over the past year. Shree Cement now has an installed capacity of 8 mn tpa, which will likely increase to 9 mn tpa by March 2009. Madras Cement's growth rates will likely revive after the commissioning of its new production facility during 3QFY08.

Cement prices remain stable at Rs231/bag. All India average cement prices in October 2007 remained stable at Rs231/bag in October 2007 (Rs202/bag in October 2006). Prices in North India increased by Rs5/bag during the month as cement manufacturer across the northern region took price increases (as had been indicated in our previous sector reports). We note that the current supply-demand balance remains in favor of cement manufacturers who are likely to retain their pricing power (barring any government intervention) for the first few months of FY2009. Commissioning of new capacities in 1QFY09 will likely change this pricing equation, in our view.

We retain our Cautious view on the sector. We note new capacities getting commissioned in FY2009 will likely change the currently favorable demand-supply environment. Grasim Industries has inducated that its expansion plans across plants remains firmly on track for commissioning in 1QFY09 and 2QFY09. We estimate 30 mn tpa of new capacity to get commissioned in FY2009, far exceeding incremental cement demand. Government intervention remains a key risk to the sector in the interim.

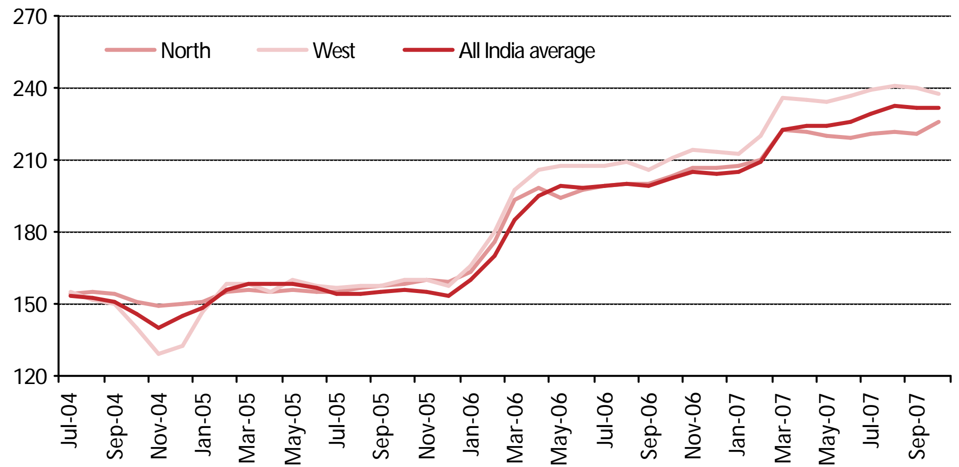
Exhibit 1: Cement despatch growth rates for major companies

	Oct-07	Growth (%)	
	(mn tons)	y-o-y	YTD
ACC	1.74	6.4	11.3
Gujarat Ambuja	1.48	3.7	2.4
UltraTech	1.19	(0.9)	5.1
Grasim Industries	1.35	2.1	7.2
Shree Cement	0.55	25.3	25.7
India Cements	0.71	13.0	5.0
Madras Cements	0.43	7.4	2.8
Industry	**13.7**	**9.0**	**8.9**

Source: CMA, Kotak Institutional Equities.

Exhibit 2: Cement prices have remained stable in October

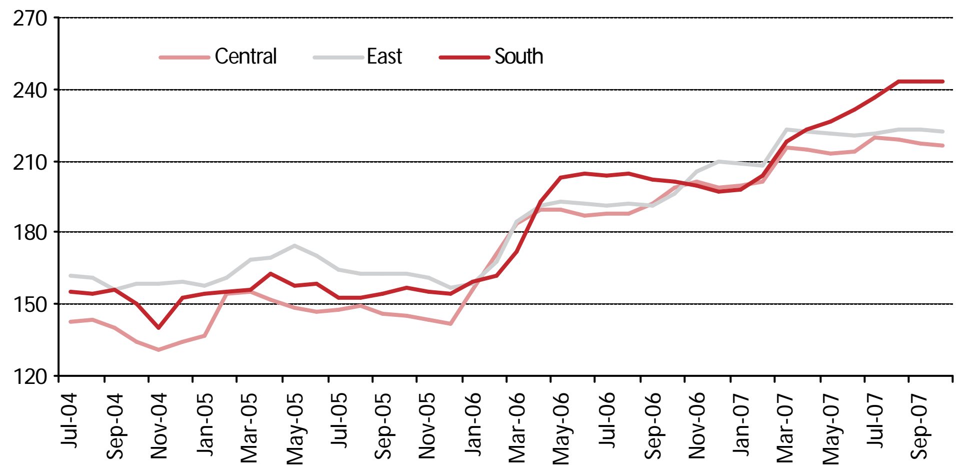
Regional cement prices (Rs per 50 kg bag)



Source: CMA, Kotak Institutional Equities.

Exhibit 3: Cement prices in the South have remained stable over the last few months

Regional cement prices (Rs per 50 kg bag)



Source: CMA, Kotak Institutional Equities.

Economy

Sector coverage view N/A

RBI lays map for the introduction of FX futures—FIIs to be in soon, but PE funds are out

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- **RBI's has recommended that the introduction of FX futures begin with the participation by residents (including banks) without limits**
- **Participation to be extended to FIIs and NRIs against exposures. However, private equity (PE) funds may not be able to participate as the report does not mention enabling FDI exposures to be hedged through FX futures**
- **Existing stock or commodity exchanges can set up separate dedicated FX future exchange and their own clearing house which would operate under the RBI regulation**

Major Implications of the RBI Working Group Report for the FX markets

We believe the RBI Working Group recommendations constitute a proposal for significant liberalization of the Indian FX markets. The following eight aspects of the recommendations are noteworthy:

1. All residents (corporates, banks or individuals) can participate as speculators on Indian rupee (INR)/ US dollar (USD) exchange rate by taking positions without underlying exposures.
2. Banks can participate in FX futures, both as trading-cum-clearing member and as professional clearing members. This would essentially mean that the banks may also be allowed to make deals for themselves as well as on behalf of the clients, and clear and settle such deals through the clearing house of the exchange. As professional clearing members, they would also be entitled to clear and settle trades executed by other members of the exchange.
3. Foreign Institutional Investors (FIIs) can participate as hedgers through authorized dealer banks and their positions could be capped subject to prudential limits based on their exposures. The RBI report has suggested that, at the introduction stage, only residents may be allowed to participate, after which the market may be extended to non-residents. However, we believe FII participation could be allowed soon given that, in its absence, the market could lack liquidity.
4. In our opinion, the proposals constitute a quantum leap for the FIIs, as they would be able to dynamically hedge (more freely cancel and rebook contracts) their portfolios through the FX-futures route, something that they are not permitted to do in the OTC segment. At present, FIIs can rebook cancelled forward contracts up to a limit of only 2% of their underlying exposure in equity and/or debt in the FX OTC market. The proposed de-facto removal of this limit through FX futures would help bring part of non-deliverable forward (NDF) markets onshore.
5. We believe that the PE funds may not be able to access FX-futures, at least directly, since the RBI report does not talk about hedging of the FDI exposures by non–residents through FX futures.
6. NRIs may also gain, as currently they are allowed to hedge to the extent of their underlying exposures and can repatriate their balances in the NRO account up to USD 1 million per financial year. We expect that RBI may now set the prudential limit for FX-futures exposure by NRIs which may at least be US$1 mn.
7. The report also hints at further liberalization of the OTC segment of the FX markets in a phased manner. This could include relaxation in the underlying criteria for corporate subject to certain disclosure requirements and removal of restrictions on cancellation and rebooking of OTC contracts for residents and relaxations in same for the non-residents.

RBI's broad thinking supportive of currency futures as an additional hedging mechanism

With an 11.3% appreciation of the INR/USD since February 2007 till date, in spite of buying US$49 bn (intervention data only available up to September 2007), RBI is now looking for ways to improve hedging capabilities of market participants. With this in view, RBI's internal Working Group has favored the introduction of currency futures in India. The introduction of currency futures is being seen as an additional step in this direction.

SEBI's in-principle approval for FX futures & options

The SEBI Board on November 14, 2007 has already approved, in principal, the introduction of seven new derivative products on November 14, 2007. These include exchange-traded currency (foreign exchange) Futures & Options. The approval was based on an interim recommendation by SEBI Committee chaired by Prof. M. Rammohan Rao. The RBI report does not talk about exchange traded options or on options on futures, but the SEBI Board's in-principal okay should cover these as well. It therefore appears that SEBI is in sync or ahead of RBI but the fine print shows that further regulatory understanding would still be needed.

SEBI's decision is broadly, but not entirely, in sync with the RBI

We believe that both RBI and SEBI are supportive of the introduction of currency futures. However, the introduction may be possible only in FY2009 as further policy clarity and groundwork is necessary.

SEBI appears to be ready for FX-F&O on stock exchanges, but the RBI report has preferred a dedicated exchange for currency futures, saying it would ensure a clean regulatory and supervisory structure and prevent the emergence of monopoly power with exchanges. It adds that existing exchanges could also set up dedicated exchanges. The working of FX futures on SEBI regulated stock exchanges may evolve only after the Ministry of Finance (MOF) takes a view. It therefore appears that the actual introduction of FX futures would be delayed, perhaps until by FY2009.

The recommended contract design and infrastructure

The contract design advocated by the Working Group envisages:

i. RBI's reference rate for spot INR per USD would to be the underlying for cash-settled futures

ii. Single contract size of US$1,000 notional value

iii. Contracts of tenors up to 12-months, preferably matching the forward tenors

iv. Mid-month expiry on the first working day after the 15th of every month

v. Market timing of 10.00 am-4.00 pm initially, to be synchronized with OTC timing of 9.00 am-5.00 pm later

vi. Dedicated exchanges for FX futures (existing exchanges can also set up separate subsidiaries) to have their own clearing houses

vii. Foreign investment in FX futures exchanges likely to be capped at 49% (26% FDI and 23% FII), as presently in case of stock exchanges

viii. Margins to be specified by clearing houses

ix. Brokers to be permitted in FX futures market

Implications of the introduction of FX futures for monetary and exchange rate policy

RBI sees risks of dollarization and increased exchange rate volatility in FX futures, but seeks to limit it through contract design. We believe that these won't be major problems for the central bank, but the size of FX markets could surely grow

The RBI report acknowledges that there could be risks of possible dollarization and increased exchange rate and financial volatility from FX futures. It, however, believes that its choice for cash settled contract vis-à-vis physical delivery contracts could limit the dollarization risks.

The envisaged introduction of the FX futures would significantly increase hedging capabilities of market participants and so obviously enhances the ability of the central bank to tolerate increased exchange rate flexibility. However, we do not see any significant changes in monetary or exchange rate policy arising out of the RBI proposal for the introduction of FX futures. It is more a policy response to already increased appreciation rate for INR. We expect the FX markets could turn more liquid after the futures are introduced. We could also see some episodes of higher volatility on account of FX futures. However, the downsides are limited. Worldwide, FX markets remain OTC driven even after the introduction of futures and they account for less than 2-percent of the total size of the FX markets.

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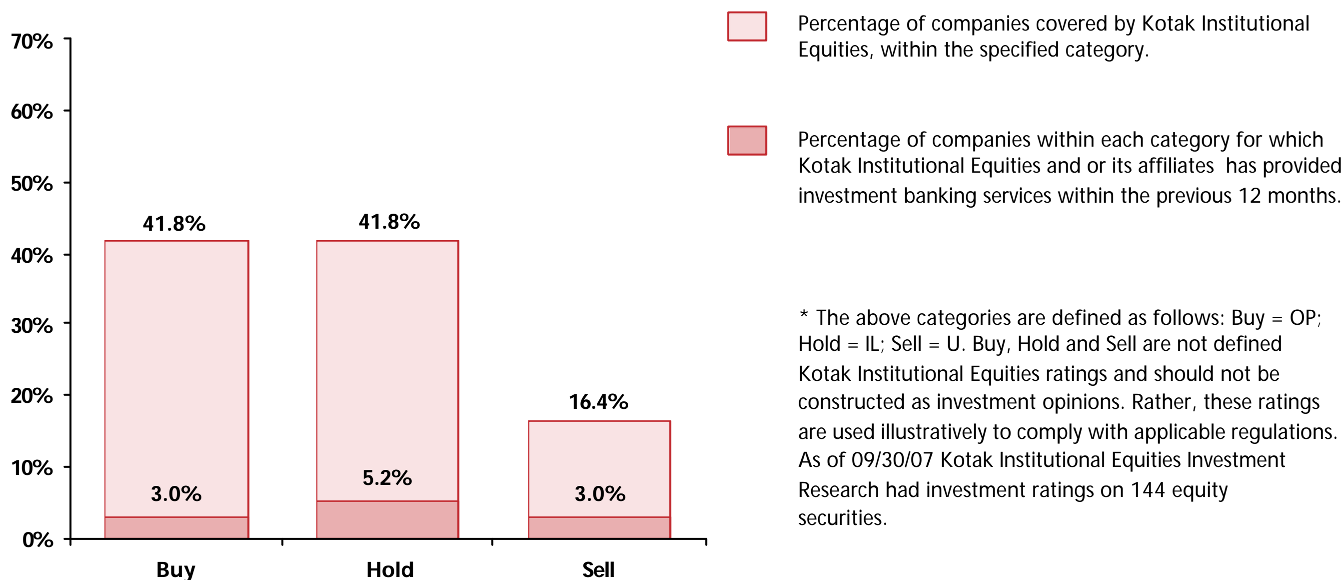

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Source: Kotak Institutional Equities. As of September 30, 2007

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