kotak Institutional Equities

INDIA DAILY

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EQUITY MARKETS

		Change, %		
India	**3-Apr**	**1-day**	**1-mo**	**3-mo**
Sensex	12,625	1.4	(2.0)	(9.0)
Nifty	3,691	1.6	(1.0)	(7.5)
Global/Regional indices				
Dow Jones	12,510	1.0	3.3	0.2
Nasdaq Composite	2,450	1.2	3.5	(0.1)
FTSE	6,366	0.8	4.1	1.3
Nikkie	17,509	1.5	1.7	0.9
Hang Seng	20,156	0.8	3.7	0.6
KOSPI	1,480	1.1	4.6	5.9

Value traded - India

			Moving avg, Rs bn	
	3-Apr		**1-mo**	**3-mo**
Cash (NSE+BSE)	95.0		113.6	126.6
Derivatives (NSE)	233.5		325.3	252.2
Deri. open interest	408.1		530.1	465.6

Forex/money market

		Change, basis points		
	3-Apr	**1-day**	**1-mo**	**3-mo**
Rs/US$	43.1	-	(162)	(122)
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	8.2	21	22	65

Net investment (US$mn)

	2-Apr		**MTD**	**CYTD**
FIIs	(108)		#N/A	40
MFs	15		#N/A	(303)

Top movers -3mo basis

		Change, %		
Best performers	**3-Apr**	**1-day**	**1-mo**	**3-mo**
SAIL	111	3.4	5.2	23.4
Punjab Tractors	303	(0.2)	(5.9)	19.8
Bharti Tele	735	0.5	3.8	15.5
BEL	1,514	3.9	1.8	13.6
Britannia	1,226	0.9	(5.1)	11.3
Worst performers				
Acc	705	0.0	(17.6)	(34.2)
Tvs Motor	57	(0.4)	(6.4)	(31.9)
Century Tex	507	0.6	(4.7)	(30.9)
Tata Motors	681	1.8	(12.1)	(28.1)
Hindalco	129	1.2	(6.3)	(26.2)

News Roundup

Corporate

- France's second-largest carmaker, Renault SA, today announced the launch of the Logan sedans in India through its joint venture with Mahindra & Mahindra and became Europe's first mass market car maker to enter Asia's fourth-biggest car market. (BS)
- The US-based Hershey Company has acquired 51 per cent stake in Godrej Beverages & Foods Ltd for US$60mn. This includes the 40 per cent equity held by IL&FS in the company, five per cent of Godrej Industries and 6 per cent from Mr A. Mahendran, Mentor and Director of the company. (BL)

Economic and political

- Finance Minister P. Chidambaram has decided to make cement imports cheaper to ease supply constraints by scrapping the 16 per cent countervailing duty and 4 per cent special additional duty on portland cement imports. This may bring the margins of domestic cement companies under pressure pending a truce on dual excise duty structure. (ET)
- World oil prices on Tuesday fell slightly, as major crude producer Iran signalled that progress had been made in trying to end its standoff with Britain over Tehran's capture of 15 British sailors. Prices nevertheless held above US$68 a barrel in London, the highest level since September 1, 2006. (ET)

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

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Infrastructure

GMRI.BO, Rs340	
Rating	OP
Sector coverage view	Attractive
Target Price (Rs)	465
52W High -Low (Rs)	437 - 205
Market Cap (Rs bn)	112.6

Financials

March y/e	2006	2007E	2008E
Sales (Rs bn)	10.6	14.7	15.4
Net Profit (Rs bn)	0.7	0.7	0.4
EPS (Rs)	2.7	2.0	1.1
EPS gth	*(38.7)*	*(24.8)*	*(45.5)*
P/E (x)	127.5	169.5	311.0
EV/EBITDA (x)	29.4	26.8	32.6
Div yield (%)	-	-	-

GMR Infrastructure: Wind on its wing

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- **GMRI builds, owns and operates airport, power and road concessions**
- **GMRI in airport development'swooping in where angels feared to tread**
- **Buy with a target of Rs465/share**
- **Commonwealth Games likely to ensure delivery on target**

GMRI, private-sector pioneer in airport development, is set to cream the opportunity provided by the dismal state of India's airports. As an early bird, we believe GMRI can capture growth and value creation potential in this space to generate above-sector returns. Buy with a target price of Rs465.

GMRI builds, owns and operates airport, power and road concessions

GMR Infrastructure (GMRI) is a developer of infrastructure projects across the airport, road and power sectors. Its current portfolio includes two airports (Delhi and Hyderabad, with 950 acres real estate), six road projects (both annuity and toll, 422 kms) and three operating power projects (810 MW). The infrastructure space offers a US$30 bn opportunity for private developers over the next five years—we believe GMRI is well placed to ride this opportunity.

GMRI in airport development—swooping in where angels feared to tread

GMRI outbid its competitors to win the Delhi and Hyderabad airport concessions, spotting immense growth and value-generation potential in airports. GMRI captures the frenetic pace of air traffic growth as well as upsides from non-traditional revenue streams and adjoining real estate by developing these airports as 'aerotropolises'. Optimal financial structuring lowers GMRI's risk profile and maximizes shareholder value, in our view.

Buy with a target of Rs465/share

Our SOTP-based target price includes assets individually valued according to DCF, the best barometer of life-cycle cash flows. Around 83% of the value comes from airports, while the road and power portfolios contribute 8% and 7%, respectively. As a bulk of the value resides in projects under implementation that have yet to generate returns, a multiple-based valuation approach would be inappropriate in our view.

Commonwealth Games likely to ensure delivery on target

GMRI's mandate to get the airports ready before the Commonwealth Games in India in September 2010 mitigates our worries on pre-construction and construction-related risks. We are troubled though, by the possibility that the yet-to-be-formed airport regulator could balk on significant tariff increases, contrary to provisions of existing agreements.

Industrials

BHEL.BO, Rs2254	
Rating	IL
Sector coverage view	Attractive
Target Price (Rs)	2,700
52W High -Low (Rs)	2668 - 1531
Market Cap (Rs bn)	551.7

Financials

March y/e	2006	2007E	2008E
Sales (Rs bn)	132.3	169.3	194.0
Net Profit (Rs bn)	16.8	31.8	31.1
EPS (Rs)	68.5	130.0	127.1
EPS gth	*75.4*	*89.9*	*(2.2)*
P/E (x)	32.9	17.3	17.7
EV/EBITDA (x)	18.0	10.6	10.0
Div yield (%)	0.6	1.0	1.3

Shareholding, December 2006

	Pattern	% of Portfolio	Over/(under) weight
Promoters	67.7	-	-
FIIs	21.7	1.9	0.0
MFs	4.6	2.5	0.6
UTI	-	-	(1.9)
LIC	1.8	0.9	(1.0)

BHEL: Strong order backlog and long-term guidance prompt earnings, price target upgrades

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- **Upgrade FY2009 estimate by a sharp 20% on the back of strong order flow numbers**
- **Revise target price to Rs2,700; upgrade the stock to OP**
- **Management targets US$10 bn revenue by 2012 and bets big on power capacity additions catching up during 11th plan**

BHEL's provisional revenue and PAT numbers for FY2007 are in-line with estimates. The order backlog of Rs550 bn, providing 2.6 years' visibility, is higher than our estimate. Based on this newsflow, we upgrade FY2009 earnings estimate by 20%. The management's new ambitious 5-year plan of US$10 bn revenues by 2012 (21% CAGR on FY2007 revenues) may factor in tailwinds of acceleration in capacity additions and strong market share. Our 2012 numbers remain below the company's vision as we may be assuming less back-endedness than the company is. Our revised DCF-based target price is Rs2,700 (earlier, Rs2,450). We upgrade BHEL to OP - we believe power sector investments will continue despite the ongoing monetory tightening. In fact, power utilities may plan their capex early to avoid slippages recurring during the 11th plan.

Provisional numbers in-line with estimates

BHEL has reported gross revenues of Rs187 bn, ahead of our estimate of Rs179 bn. PBT of Rs36.75 bn and PAT of Rs23.85 bn were lower than estimate by 3% and 2.7% respectively. BHEL does not report other break-ups with these provisional numbers. We believe BHEL made Rs1 bn provision for wage cost revisions (likely in early FY2010), but that could not have caused margin to trail estimate, as we were estimating Rs1.2 bn wage cost provision for the year. We believe material / employee cost may have been higher than estimated. (Exhibit 1: provisional numbers and estimates)

Order flows continue to surprise

BHEL has reported an order backlog of Rs550 bn, higher than our estimate of Rs513 bn. We believe two key orders, NTPC-Simhadri-III (1,000MW, c.Rs30 bn) and ONGC's onshore rig refurbishment (Rs6.5 bn) account for the difference. The order backlog provides a visibility of 2.8 years, based on FY2008E revenues. BHEL thus recorded another record year of order flows, with orders of Rs356 bn (up 88% YoY). (Exhibit 2: order flow and backlog)

BHEL's ambitious 11th plan target implies 21% CAGR in revenues

The management in its press conference has shared its 5-year plan of US$10 bn revenues by 2012, implying 21% CAGR on FY2007 revenues. We believe a revenue target in itself does not mean much for an engineering company. A skew in revenue recognition towards the end of the 11th plan period could boost 2012 revenues but from a valuation perspective, a more uniform spread of revenues is far more valuable. Thus, the targeted MW of deliveries through the 5-years and execution pattern are important data points. In its assumptions, We believe BHEL is betting on the following tailwinds:

1) While power capacity additions during the 10th plan trailed estimates comprehensively, 11th plan may make up for this shortfall – implying a total power capacity addition of 76GW during FY2008-12. Power capacity addition for the 10th plan will likely be c.23GW versus the original plan of 41GW, implying shortfall of 18GW.

2) Maintain market share of 60% in the Indian power plant equipment market. Given that UMPPs (which BHEL may likely lose) would mostly be commissioned during the 12th plan, BHEL is well-placed to maintain its market share. As per our revised estimate, BHEL may have clocked a market share of 70% during the 10th plan.

3) Continued growth in the industry segment at around 10% CAGR

4) R&M of existing power plants

We believe BHEL's targets assume everything goes right; our estimates remain below the company's targets

We have made marginal upward adjustments to BHEL's estimated deliveries during FY2008-12. Importantly, given the strong order backlog, we believe the revenue recognition would be less back-ended than assumed earlier. We upgrade our estimates for FY2009 by 20%. Our FY2012 estimate remains significantly below BHEL's guidance as we estimate a more uniform order receipt and execution than what BHEL may be assuming.

We believe BHEL will hold up amidst concerns on monetory tightening

Massive power deficits necessitate large investments in the power sector. The comfort of an interest-cost pass-through structure and strong balance sheets of central government utilities would ensure that they would not hold back power capex. On the other hand, they may plan their capex early to avoid bunching of projects towards the end of the plan period. Based on our earnings upgrades, we revise our DCF-based target price to Rs2,700 and upgrade the stock to OP (earlier, In-line). Key catalysts include negotiated order from NTPC for eight 800MW units, award of ultra mega projects and strong order execution.

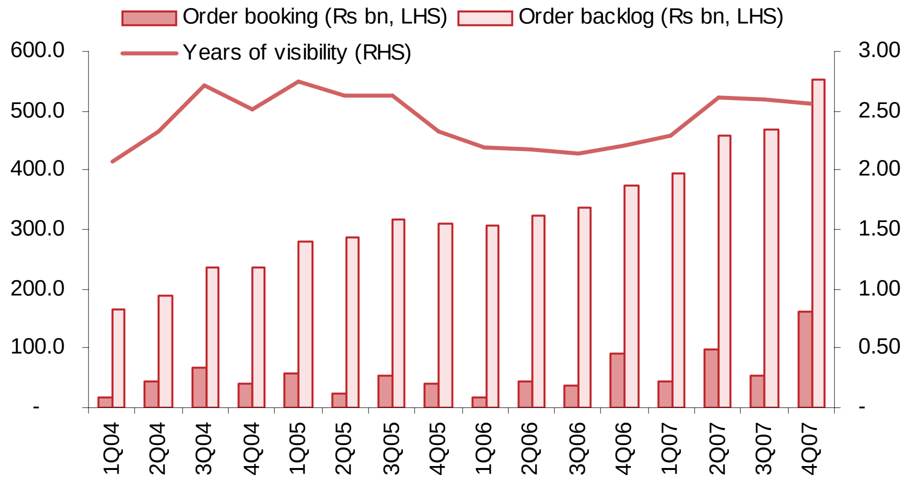
BHEL 4QFY07 result - key numbers (Rs mn)

		yoy			qoq			yoy		
	FY08E	**4QFY07**	**4QFY06**	***% change***	**4QFY07**	**3QFY07**	***% change***	**FY07**	**FY06**	***% change***
Gross Sales	214,808	187,020	60,706	208	187,020	47,099	297	187,020	145,873	28
PBT	**47,717**	**36,750**	**13,247**	**177**	**36,750**	**10,365**	**255**	36,750	**25,644**	**43**
PAT	**30,983**	**11,207**	**8,680**	**29**	**11,207**	**6,676**	**68**	**23,850**	**16,792**	**42**
EPS	127	46	35	29	46	27		97	69	42

Source: Company data, Kotak Institutional Equities Estimates

Exhibit 2. BHEL's order backlog provides visibility of 2.6 years

Order booking, Order backlog & visibility trend for BHEL



Source: Company data, Kotak Institutional Equities

BHEL may have assumed best case scenario for its US$10 bn target

		10th plan (FY2003-07)	11th plan estimates (FY2008-12)		
			Current	Revised	BHEL's likely assumptions
Power capacity addition (MW)		23,000.0	75,000.0	75,000.0	75,000.0
BHEL's market share (%)		**70.0**	**52.6**	**55.0**	**60.0**
BHEL's deliveries (MW)		16,100.0	39,479.8	41,250.0	45,000.0
Price realisation per MW		**26.9**	**24.6**	**25.0**	**26.0**
Revenues (Rs bn)		433.7	970.2	1,031.3	1,170.0
Industry, exports and R&M revenues (Rs bn)		172.8	345.7	345.7	345.7
Total revenues (Rs bn)		**606.5**	**1,315.8**	**1,376.9**	**1,515.7**
Phase-out of revenues (year-wise, %)					
	1	12.7	16.4	15.7	14.5
	2	14.6	17.9	19.0	17.5
	3	17.6	19.9	20.0	18.0
	4	24.1	21.8	21.0	20.0
	5	31.0	24.0	24.3	30.0
Phase-out of revenues (Rs bn)					
	1	77.2	215.6	216.2	219.8
	2	88.4	235.2	261.6	265.2
	3	106.9	261.4	275.4	272.8
	4	145.9	287.5	289.2	303.1
	5	188.2	316.1	334.6	$\boxed{\textbf{454.7}}$

Source: Kotak Institutional equities estimates

Industrials

BAJE.BO, Rs1514	
Rating	IL
Sector coverage view	Attractive
Target Price (Rs)	1,450
52W High -Low (Rs)	1794 - 815
Market Cap (Rs bn)	121.1

Financials

March y/e	2006	2007E	2008E
Sales (Rs bn)	36.5	41.9	49.7
Net Profit (Rs bn)	6.0	6.9	8.3
EPS (Rs)	75.2	86.3	103.3
EPS gth	*23.9*	*14.8*	*19.7*
P/E (x)	20.1	17.5	14.7
EV/EBITDA (x)	10.3	8.6	7.0
Div yield (%)	1.0	1.5	1.7

Shareholding, December 2006

	Pattern	% of Portfolio	Over/(under) weight
Promoters	75.9	-	-
FIIs	11.6	0.2	(0.2)
MFs	5.3	0.6	0.2
UTI	-	-	(0.4)
LIC	1.7	0.2	(0.2)

Bharat Electronics: Provision numbers in-line with estimates but order flows very strong

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- **BEL reports provisional numbers; meets full-year estimates via strong 4Q growth**
- **Reports order book of Rs91 bn substantially ahead of estimates, improving visibility for FY2008 and 2009**
- **Earnings upgrade of 4% and 11% for FY2008 and 2009 respectively; higher target price of Rs1,450 (earlier Rs1,375)**
- **Maintain In-line**

Bharat Electronics provisional revenue and PBT numbers (standalone) are in-line with our estimates. After a disappointing 9m, the company has reported 25% PBT growth in 4Q07 to meet our full-year estimates. BEL has surprised us by announcing an order book of Rs91 bn, way ahead of our estimate of Rs65 bn. We believe the order book includes regular defense orders and does not include offset-related orders. The announcement makes us more confident that BEL will achieve its revenue target of Rs50 bn in FY2008, and thus we upgrade FY2008 and 09 net earnings numbers by 4% and 11% respectively. Our revised target price is Rs1,450/share. Maintain In-line.

BEL meets our estimates

BEL has reported stand-alone revenue of Rs39.6 bn (1% lower than our estimate of Rs40.2 bn) and PBT of Rs10.4 bn (in-line with our estimate of Rs10.47 bn). BEL does not provide any other break-ups in its provisional numbers. After a disappointing 9m, the company has reported 25% PBT growth in 4Q07 to meet our full-year estimates.

Order book of Rs91 bn way ahead of estimates

BEL has surprised us by announcing an order book of Rs91 bn, way ahead of our estimate of Rs65 bn. The significant orders received during the year include the Artillery Combat Command & Control System, Electronic Warfare systems, STARS V Mk II - a secure tactical radio in VHF band, and Naval Systems for P28 and P15A class of ships. We believe these are regular defense related orders and there are no offset-related orders. The order book implies that the company witnessed new orders of Rs65 bn in FY2007, a 61% YoY growth. The visibility has now improved to 2 years of FY2008 revenues (earlier 1.6 years).

Raising our EPS estimates by 4% and 11% for FY2008 and 2009

BEL's comfortable order book makes us more confident that the company will achieve its revenue target of Rs50 bn in FY2008. Thus we upgrade FY2008 and 09 earnings numbers by 4% and 11% respectively, on the back of revenue upgrades of 3% and 7% respectively. Our revised DCF-based target price is Rs1,450, implying FY2008 P/E of 14x. We maintain In-line on the stock.

BEL has reported strong order flows during FY2007

	2001	2002	2003	2004	2005	2006	2007E
Orders received	19.5	30.0	52.7	24.9	26.4	40.3	64.5
% growth	(12.8)	53.7	75.5	(52.7)	6.2	52.3	**60.1**
Less: Sales (Unconsolidated)	16.7	19.0	24.7	27.4	31.9	35.0	39.8
% growth	14.4	13.7	30.1	11.1	16.3	9.9	13.6
Closing backlog	**30.0**	**41.0**	**69.0**	**66.5**	**61.1**	**66.3**	**91.0**
% growth	10.5	36.9	68.3	(3.6)	(8.2)	8.6	37.2
Visibility	**1.6**	**1.7**	**2.5**	**2.1**	**1.7**	**1.7**	**1.9**

Source: Company data, Kotak Institutional Equities estimates

Automobiles

MAHM.BO, Rs728	
Rating	OP
Sector coverage view	Attractive
Target Price (Rs)	1,000
52W High -Low (Rs)	1002 - 488
Market Cap (Rs bn)	186.8

Financials

March y/e	2006	2007E	2008E
Sales (Rs bn)	79.9	99.0	119.5
Net Profit (Rs bn)	6.5	8.7	11.3
EPS (Rs)	35.6	51.2	67.8
EPS gth	*51.8*	*43.7*	*32.5*
P/E (x)	20.4	14.2	10.7
EV/EBITDA (x)	14.4	9.5	7.1
Div yield (%)	1.1	1.2	1.5

Shareholding, December 2006

	Pattern	% of Portfolio	Over/(under) weight
Promoters	23.0	-	-
FIIs	41.0	1.4	0.7
MFs	6.3	1.3	0.6
UTI	-	-	(0.8)
LIC	9.8	2.0	1.2

Mahindra & Mahindra: M&M drives into car market with 'Logan

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- **Mahindra-Renault launches 'Logan' at an aggressive price**
- **Neutral for M&M in near-term but success is important from long-term perspective**

Mahindra Renault Ltd – M&M’s 51:49 joint venture with Renault has launched its first car in India - the ‘Logan’. The ‘Logan’ is a low-frills car platform that Renault has developed specifically for emerging economies. It is currently being sold in 51 countries around the world. In India the ‘Logan’ will be available in 3 petrol and 2 diesel versions. The petrol versions will span the price range of Rs435,000 to Rs576,000 while the diesel versions will cost Rs554,000 to Rs651,000. The diesel variants will be based on the common rail engine technology, which is now becoming the norm for diesel cars in India. The ‘Logan’ has been positioned as a spacious car offering good looks and high performance at an affordable price. The ‘Logan’ will now be the cheapest mid-size car in India. The lowest variant of the ‘Logan’ priced at Rs435,000 (on-road price Rs480,000) will not provide power steering. In our opinion, power steering is now a hygiene factor for every car buyer with a budget of over Rs450,000 and do not expect great demand for the lowest version. We expect the second-lowest variant costing Rs480,000 (on-road price Rs530,000) to be the volume driver for the ‘Logan’. The ‘Logan’ will be manufactured at the Mahindra Renault plant at Nashik in Maharashtra, which has a capacity of 50,000 units per annum. The ‘Logan’ will be available in 10 cities initially and will be expanded to 25 cities by May. The all India launch will happen in November.

Implications for M&M: Neutral in near-term but success is important from long-term perspective

In our view, near-term impact of the ‘Logan’ launch will be neutral from M&M’s perspective. We understand that localization content of the ‘Logan’ is 55% due to which profitability in FY08 will be relatively muted. The company has plans to take localization content up to 70% in FY09. However, further increase in localization content beyond 70% will happen only when Renault’s engine and transmissions facility comes up in 2009. We are currently adding no value for ‘Mahindra Renault’ in our estimates and valuations for M&M. Profitability of Mahindra Renault could become meaningful only in FY09 when both volumes and localization content moves up.

Success of the Logan is crucial for M&M given its aspirations in the passenger car market. A successful launch will translate into greater traction for M&M’s second joint venture in cars with Renault and Nissan, which is expected to commence production in 2009.

Implications for Maruti: Logan will compete with 'Swift' and 'Esteem' (13% of Maruti's sales)

At an on-road price-tag of Rs480,000 upwards, the 'Logan' will compete with Maruti's 'Swift' and 'Esteem', which together account for 13% of Maruti's sales. We expect the 'Swift' to continue to do well for Maruti on the back of the launch of the diesel version of the model. We understand that the diesel 'Swift' has a waiting list of more than a month. Maruti's 'Esteem' sales might come under further pressure post the 'Logan' launch but will not matter much as the 'Esteem' accounts for just 3% of Maruti's sales. We don't see the 'Logan' affecting volume of the 'WagonR' and the 'Zen Estilo' due to the meaningful price differential between them. We maintain our 11% domestic growth estimate for Maruti in FY08.

Implications for Tata Motors: 'Logan' could impact demand for the 'Indigo'

The 'Logan' will compete with Tata Motors 'Indigo', which accounts for 19% of Tata Motors' passenger car sales. The 'Indigo' has not been doing well for Tata Motors in the last 12 months. The recent launch of the 'Indigo XL' has revived sales of the model to some extent. However, this could change once again if the 'Logan' becomes a success. We currently estimate 10% domestic car growth for Tata Motors in FY08.

Other key features of the 'Logan'

- Fuel efficiency: 10-13 km/litre for petrol and 14-18 km/litre for diesel
- Engine: 1.4L and 1.6L for petrol and 1.5L for diesel
- Power: 75 HP and 90 HP for petrol and 65 HP for diesel

Comparison of Logan with Swift, Esteem and Indigo

	Logan (Petrol)	Logan (Diesel)	Maruti Swift (Petrol)	Maruti Swift (Diesel)	Maruti Esteem	Tata Indigo
Price range (Rs)	Rs435,000 to Rs576,000	Rs554,000 to Rs651,000	Rs411,000 to Rs495,000	Rs475,000 to Rs500,000	Rs440,000 to Rs505,000	Rs419,000 to Rs521,000
Displacement (CC)	1400/1600	1500	1300	1300	1300	1400
Power (BHP)	75HP/90HP	65HP	88HP	75HP	86HP	68HP

Source: Company, Kotak Institutional Equities

Banking

Sector coverage view			Neutral

		Price, Rs	
Company	**Rating**	**3-Apr**	**Target**
SBI	OP	927	1,200
HDFC	IL	1,424	1,300
HDFC Bank	IL	913	1,000
ICICI Bank	OP	804	950
Corp Bk	U	266	340
PNB	OP	427	610
OBC	U	178	240
Canara Bk	OP	184	320
LIC Housing	U	135	160
UTI Bank	IL	465	435
IOB	OP	99	130
Shriram Transp	OP	116	155
SREI	OP	46	73
MMFSL	OP	225	280
Andhra	OP	72	115
IDFC	IL	78	85

Introduction of mortgage guarantee companies will likely promote sub prime mortgage lending

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- **RBI releases draft guidelines for operations of mortgage guarantee companies (MGCs),**
- **Availability of MGCs will likely promote sub-prime lending over a long term,**
- **However, absence of comprehensive default statistics may constrain efficient risk pricing.**

RBI has released draft guidelines for operations of mortgage guarantee companies (MGC). In our view, the effectiveness of this business model depends on the ability of MGCs to add value to financiers by either (a) charging lower guarantee fees (than historic credit losses) or (b) facilitating the financier to venture into newer (specially sub prime) markets. Most of the large financiers except HDFC and LICHF have seen less than one complete home loan cycle (about 15 years) unlike US financiers which have decades of experience. As such, in the absence of comprehensive statistics on defaults, it may likely be difficult for MGCs to charge competitive premiums.

Salient features for MGCs

- Minimum Capital: Rs1 bn on commencement; Rs3 bn within three years,
- Overall capital adequacy ratio: 12% of which 8% should be Tier I,
- Maximum loan to value ratio for the underlying loan: 90%,
- No single guarantee can exceed 10% of overall capital (Tier I and II).

Cement

Sector coverage view	Neural

Company	Rating	Price, Rs 3-Apr	Target
Gujarat Ambuj	IL	105	110
ACC	IL	705	810
Grasim	OP	2,104	2,440
India Cements	IL	156	170
UltraTech Cem	IL	713	710
Shree Cement	OP	908	1,090

Government determined to see lower prices, risks outweigh returnsGovernment determined to see lower prices, risks outweigh returns

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- **Landed cost of cement competitive against the domestic cement in coastal areas**
- **While no price increases limits the possible earnings surprise, potential negatives are on the rise**
- **Reduce rating on the sector to cautious—the worst may not be over yet**

At a time when the cement manufacturers are making historic-high EBITDA per tonne of cement, the bad news for the industry does not seem to be coming to end. Media reports suggest that Government of India has removed the 16% countervailing duty (CVD) and 4% special addition duty (SAD) on cement imports. We estimate the landed cost of cement (at Rs184/bag) to be lower than the prevailing domestic cement prices in coastal areas. While we believe that cement imports may not be easy due to the inherent bottlenecks of port infrastructure and complexities of distribution logistics, the price differential is an incentive for large bulk consumers located in coastal areas to invest in bulk handling and bagging facilities. While the cut in CVD may not immediately translate into reduction in cement prices, this may not be an end to Government's initiatives to reduce cement prices, in our view. We believe that risks outweigh the potential returns in cement sector and reduce our sector rating to Cautious (from Neutral). We have reduced our target prices for cement stocks by 5-15%.

Landed cost of cement competitive against the domestic cement in coastal areas. Media reports suggest that Government of India has removed the 16% countervailing duty and 4% special addition duty (SAD) on cement imports. We estimate the landed cost of cement in coastal areas (Rs184/bag) to be competitive with domestic cement (Rs215-225/bag) making it a seemingly attractive option. The imports will likely be even more viable for bulk consumers importing for captive usage in bulk as they will not be required to pay for 12.5% VAT as well. We note several constraints in importing and selling cement in the local market and do not expect an immediate reduction in cement prices—(1) lack of sufficient bulk handling facilities capable of unloading cement at the ports; (2) need to install packaging facility at the ports to pack the imported bulk cement into bags; (3) distribution and logistics complexities—imported cement will be competitive only in a small zone around the ports after which the freight costs make the imported cement expensive; (4) cement sold in India has to be tested and approved as per the Indian standards.

We suspect more may come. We suspect the government may initiate more steps if the cement prices do not come down. We note that the Finance Minister has been asking the cement manufacturers to reduce cement prices and help the government in keeping the inflation under check. Earlier the government had removed customs duty and introduced a differential excise duty intended at lowering cement prices. Further steps could involve a ban on cement exports and reduction in import duty on clinker.

Potential negatives outweigh likely positives. While government intervention remains the biggest negative in the sector, commitment given by cement manufacturers to keep the cement price unchanged limits potential positive earnings surprise. We estimate the gains from volumes growth in FY2009 to be neutralized by increase in costs and marginal weakness in cement prices. We highlight the potential negative triggers for the sector:

- Removal of coal linkages or increase in price of coal sold to cement manufacturers or increase in royalty rates (applicable for limestone as well) will likely add to costs, while cement manufacturers have committed to keep the prices stable for a year.
- Ban on cement and clinker exports will make available additional supplies (7-8mn tpa) in the domestic market.
- Rising interest rates resulting in slowdown in real estate and construction.
- Capacity addition in Middle East. Large capacity additions (30-35 mn tpa) in the Middle East is likely to commission during the next 18 months. This could potentially dry up the exports from India, Indonesia and Thailand.
- Slowdown in US housing market and consequently cement demand could impact cement exports from South East Asia. These supplies may get diverted to other Asian markets (including India) lowering the regional prices.

Loss of pricing power to reflect in valuation multiples. We believe that the premature loss in pricing power of the cement manufacturers will reflect in the valuation multiples of cement stocks as well. While new capacities (~14 mn tonnes) are expected to commission during FY2008, we believe that the supply-demand dynamics will remain in favor of cement manufacturers at least for the next 12-15 months. We have further reduced the premium (or discount) we assign for EV/GCI to trade over CROGCI/WACC to reflect this loss in pricing power. Consequently, our target prices for cement companies have been reduced by 5-15%. We have reduced our sector rating to Cautious. Grasim and Shree Cement are adding significantly to their capacities and are the two value players, with EV/tonne of capacity close to replacement costs.

Revision in target prices for cement companies

	Target price		
	revised	**old**	**change %**
ACC	810	890	(9.0)
Gujarat Ambuja	110	117	(6.0)
Grasim Industries	2,440	2,580	(5.4)
UltraTech Cement	710	800	(11.3)
Shree Cement	1,090	1,275	(14.5)
India Cements	170	200	(15.0)

Source: Kotak Institutional Equities estimates.

The removal of countervailing duty makes imported cement highly competitive near the coastal areas
Calculation of landed cost of cement, Rs per tonne

CIF cost, US$	**50**	Equivalent to FOB price from India to Gulf; similar quotes available from Thailand.
Exchange rate, Rs per US$	44	
CIF cost, Rs	2,200	
Customs duty (%)	-	Reduced to NIL in January 2007
Countervailing duty (%)	**-**	**Reduced to NIL**
Landed cost of cement	2,201	
Local freight and warehouse charges	400	
Bagging cost	400	
Sales tax (VAT @12.5%)	375	Sales tax will not be applicable for imports for self-consumption by large bulk users.
Dealer margin and handling charges	300	
Retail price of imported cement	3,676	
in US$ per tonne	84	
in Rs per 50 kg bag	**184**	
Current cement price, Rs per bag	219	
Premium to landed cost (%)	**19**	

Source: Kotak Institutional Equities estimates.

Cement comparative valuation

	Market cap.	CMP (Rs)	Target	Rating	EPS (Rs)				P/E (X)			
Company	(US$ mn)	3-Apr	price		2006	2007E	2008E	2009E	2006	2007E	2008E	2009E
ACC	2,933	705	810	IL	31.5	56.3	66.4	66.5	22.4	12.5	10.6	10.6
Gujarat Ambuja	3,527	105	110	IL	5.5	8.6	9.6	9.6	19.0	12.2	10.9	11.0
Grasim Industries	4,288	2,104	2,440	OP	103.6	123.3	215.2	238.9	20.3	17.1	9.8	8.8
UltraTech Cement	1,972	713	710	IL	13.7	20.6	62.7	76.1	51.8	34.6	11.4	9.4
Shree Cement	703	908	1,090	OP	48.0	101.6	112.2	127.4	18.9	8.9	8.1	7.1
India Cements	899	156	170	IL	1.5	19.3	21.6	23.2	103.2	8.1	7.2	6.7

	EV/EBITDA (X)				EV / ton production (US $)		EV/ton - capacity (US $)
Company	2006	2007E	2008E	2009E	2007E	2008E	2008E
ACC	13.4	7.5	6.6	6.2	154.3	140.7	122.7
Gujarat Ambuja	13.4	8.7	5.9	5.6	240.1	190.7	162.0
Grasim Industries	9.6	5.1	5.0	4.2	NA	NA	NA
UltraTech Cement	16.6	6.8	6.5	5.5	137.8	127.4	99.2
Shree Cement	14.6	6.0	4.9	4.1	167.9	131.4	86.6
India Cements	21.1	7.6	5.4	4.5	148.7	134.3	100.2

Note: Gujarat Ambuja - assumed exercise of put option for stake in ACIL.
ACC - 2006 numbers for 12 months ending March 2006 (adjusted) and 2007 numbers for 12 months ending Dec 2006.
Gujarat Ambuja - 2006 numbers for 12 months ending June 2006 and 2007 numbers for 12 months ending Dec 2006 (adjusted).

Source: Company reports, Kotak Institutional Equities estimates.

Calculation of target prices using our multi-stage valuation process

	Shree Cement	Gujarat Ambuja	India Cements	UltraTech Cement	ACC
March 2008 / Dec 2007 CROGCI/WACC (x)	2.54	2.19	1.40	1.84	2.08
Assigned premium of EV/GCI to CROGCI/WACC (%)	(31)	(4)	(17)	(18)	17
Assigned EV/GCI (x)	1.74	2.09	1.17	1.51	2.43
GCI (Rs bn)	24.0	66.3	44.8	63.1	60.9
EV (Rs bn)	41.9	138.3	52.2	95.6	147.9
Net debt (Rs bn)	3.9	(29.5)	8.2	6.5	(4.4)
Market capitalization (Rs bn)	38.0	167.8	44.0	89.1	152.4
No. of shares (fully diluted)	34.8	1,505.6	261.4	124.5	187.2
Target price (Rs)	**1,090**	**110**	**170**	**710**	**810**

Source: Kotak Institutional Equities estimates.

SOTP valuation of Grasim
(Rs mn)

Sum of the Parts		Methodology
Cement	179,698	7X EV/EBITDA - compared to ACC's historic average EV/EBITDA of 10X
VSF	37,797	DCF value implying an EV/EBITDA of 4.6X on FY2008E
Sponge iron	1,508	Net asset value
Others (Chemicals)	5,896	DCF value implying an EV/EBITDA of 5.5X on FY2008E
Value of key investments	18,070	20% discount to current market price
Total EV	**242,970**	
Net debt	19,093	
Market capitalization	223,877	
Number of shares o/s (mn)	91.7	
Implied share price (Rs)	**2,442**	
Target price (Rs)	**2,440**	

Implied EV/tonne of US$114/tonne for cement business.

Source: Company data, Kotak Institutional Equities estimates

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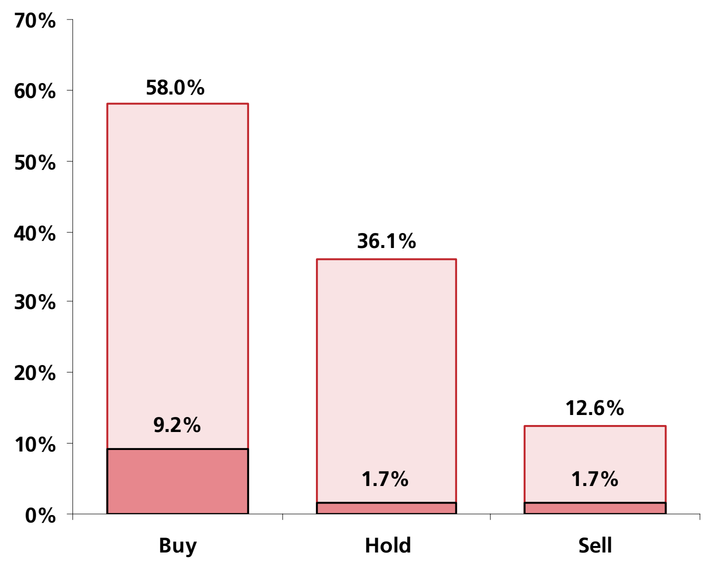

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