# Sharekhan Top Picks

In a smart month-end rally, the equity market recovered the losses posted during the better part of the last month. The move was quite similar to the one seen in the previous month, ie May 2011. Consequently, the benchmark indices have oscillated in a fairly narrow range for the past two months. After the flattish returns in May, the benchmark indices, the Nifty and the Sensex, gained marginally by 1.4% and 1.5% respectively whereas the CNX Midcap Index remained largely flat compared to the levels recorded at the time of the release of our previous Top Pick report. In comparison, our Top Picks basket gained by 2.2% during the same period. The outperformance was aided by a 10% gain in Yes Bank and around 6% appreciation in Bharat Heavy Electricals Ltd (BHEL) and IL&FS Transportation Networks.

We are making three changes to the portfolio this time around. As part of the churn within the sector, we are replacing NIIT Technologies with HCL Technologies purely due to the latter's attractive valuations and our expectations of strong quarterly results. Similarly, in case of banks, Federal Bank replaces Yes Bank, which has appreciated considerably recently. Another change is the introduction of GAIL India in place of Sintex Industries. GAIL India is one of the beneficiaries of the softening crude oil prices which has resulted in a lower subsidy burden for the oil marketing companies.

| Name | CMP* (Rs) | PER (x) | | | RoE (%) | | | Price target | Upside (%) |
|---|---|---|---|---|---|---|---|---|---|
| | | FY11 | FY12E | FY13E | FY11 | FY12E | FY13E | | |
| BHEL | 2,050 | 18.7 | 16.1 | 13.9 | 29.8 | 25.4 | 24.5 | 2,596 | 27 |
| Divi's Laboratories | 795 | 24.5 | 20.8 | 16.7 | 23.9 | 24.2 | 25.9 | 1,047 | 32 |
| Federal Bank | 450 | 13.1 | 10.2 | 8.1 | 12.0 | 13.8 | 15.3 | 500 | 11 |
| GAIL India | 450 | 16.0 | 14.6 | 12.8 | 19.8 | 19.0 | 18.8 | 567 | 26 |
| Godrej Consumer | 432 | 29.0 | 24.3 | 20.6 | 34.6 | 28.5 | 27.6 | 462 | 7 |
| HCL Tech | 495 | 20.4 | 15.2 | 11.9 | 24.8 | 27.8 | 29.2 | 622 | 26 |
| ITC | 202 | 31.3 | 25.7 | 21.7 | 33.2 | 34.5 | 33.4 | 223 | 11 |
| ITNL | 216 | 9.6 | 8.8 | 7.3 | 23.0 | 18.1 | 16.9 | 383 | 78 |
| Lupin | 449 | 23.2 | 20.5 | 16.7 | 26.3 | 22.8 | 21.6 | 520 | 16 |
| Mahindra & Mahindra | 691 | 16.5 | 15.9 | 13.9 | 22.9 | 22.0 | 21.3 | 735 | 6 |
| PTC India | 79 | 16.7 | 15.3 | 11.2 | 6.2 | 6.7 | 8.7 | 114 | 45 |

* CMP as on July 01, 2011



Sharekhan
Your guide to the financial jungle

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| Name | CMP (Rs) | PER (x) | | | RoE (%) | | | Target price | Upside (%) |
|---|---|---|---|---|---|---|---|---|---|
| | | FY11 | FY12E | FY13E | FY11 | FY12E | FY13E | | |
| **BHEL** | **2,050** | 18.7 | 16.1 | 13.9 | 29.8 | 25.4 | 24.5 | **2,596** | 27 |

**Remarks:**

- Bharat Heavy Electricals Ltd (BHEL) is a premier power generation equipment manufacturer and a leading EPC company. It has emerged as the prime beneficiary of the four-fold increase in the investments in the power sector in India.
- BHEL currently has orders worth Rs164,130 crore on hand, which provides revenue coverage for the next three to four years. We believe the order inflow momentum would remain strong for the company. However, the key challenge for BHEL would be the timely execution of projects.
- The company has already expanded its capacity to 15GW in FY11. Also, the project to expand the capacity to 20GW by FY12 is being executed on a fast track. In our view, the stabilisation of the new capacity coupled with the de-bottlenecking of the supply chain would aid order execution and sustain robust growth in BHEL's revenues in the coming years.
- The near-term positive trigger in the stock is the order inflow in the power equipment business. The current valuation at 13.9x its FY13E earnings are also looking attractive. We have, therefore, included BHEL amongst our Top Picks.

| Name | CMP (Rs) | PER FY11 | PER FY12E | PER FY13E | RoE FY11 | RoE FY12E | RoE FY13E | Target price | Upside (%) |
|---|---|---|---|---|---|---|---|---|---|
| **Divi's Laboratories** | **795** | 24.5 | 20.8 | 16.7 | 23.9 | 24.2 | 25.9 | **1,047** | 32 |

**Remarks:**

- Coupled with an IPR-respecting and "non-compete with customer" policy, Divi's Laboratories (Divi's) has an unstinted focus on the contract manufacturing (CM) space, thereby edging over its Indian peers.
- Its India-centric business model develops and produces all APIs/intermediates with a substantial cost advantage. Divi's enjoys EBITDA margin of >40% each, possibly the highest amongst its peers globally.
- After a full year of inventory downsizing, the outstanding results in H2FY11 have re-affirmed our confidence in the company's growth potential. The biggest thrust is likely to come in FY12 as the new facility at Vishakhapatnam is fully operational. The nutraceutical business could become a big opportunity with limited competition.
- A near debt-free balance sheet and strong cash flow (FCF likely to reach Rs306 crore by FY13E) are likely to help build a war chest for pursuing strategic investments (biosimilars).
- The appreciation of the rupee and slowdown in R&D allocation of the MNC clientele remain the key challenges for the company.
- With the order inflow picking up from H2FY11 and its new plant getting operational, Divi's has a strong revenue growth visibility and the operating leverage in the business will boost its margins. Consequently, we estimate the company's revenue and earnings would grow at CAGR of 23% and 21% respectively over FY11-13.

| Name | CMP | PER (x) | | | RoE (%) | | | Target | Upside |
|---|---|---|---|---|---|---|---|---|---|
| | (Rs) | FY11 | FY12E | FY13E | FY11 | FY12E | FY13E | price | (%) |
| **Federal Bank** | **450** | 13.1 | 10.2 | 8.1 | 12.0 | 13.8 | 15.3 | **500** | 11 |

**Remarks:**

- Federal Bank is among the old private sector banks with a network of 743 branches and a dominant presence in southern India. The bank is mainly focused on SME and retail segments which together constitute about 60% of the loan book. Under the new management, the bank is working on a strategy to gain pan-Indian presence, increase the efficiency, diversify loan book and improve the asset quality.
- The asset quality of the bank showed a marked improvement in Q4FY11 as the gross and net NPAs dropped to 3.5% and 0.6% from 4.0% and 0.8% respectively in Q3FY11. Going forward, with the initiatives taken by the management and the increased recoveries the NPAs are likely to decline further.
- Federal Bank's loan growth has slowed over the past several quarters due to a rise in the slippages. However, the loan growth re-bounded in FY11 showing a growth of 19% YoY driven by corporate lending as the bank plans to diversify the loan book which is skewed towards the retail and SME segments.
- The bank's return ratios have remained subdued ever since it raised capital, which is likely to go up led by an increase in the profits. We expect an RoE of about 15.3% and RoA of around 1.3% by FY13 led by a 27% CAGR in the earnings.
- Federal Bank is likely to clock earnings growth of 27% CAGR over FY11-13 (compared to a 17% CAGR over FY08-011) led by a steady growth in the balance sheet and a decline in the credit costs. Given the strong presence in south India, the expanding reach in the rest of India, an improving asset quality and a revival in its earnings the bank should trade at a higher valuation. We maintain Buy with a price target of Rs500 (1.2x FY13 BV).

| Name | CMP | FY11 | FY12E | FY13E | FY11 | FY12E | FY13E | Target price | Upside (%) |
|---|---|---|---|---|---|---|---|---|---|
| **GAIL India** | **450** | 16.0 | 14.6 | 12.8 | 19.8 | 19.0 | 18.8 | **567** | 26 |

**Remarks:**

- GAIL India, a leading gas transmission company, is aggressively expanding its pipeline network and plans to invest more than Rs30,000 crore over FY10-14 in a phased manner to double its gas pipeline network to over 14,000km and its transmission capacity to around 300mmscmd. This provides strong revenue visibility in its core gas utilities business.
- We also see value accretion from doubling of the petrochemical capacity by FY2014, and the exploration and production (E&P) and city gas distribution (CGD) businesses going forward.
- A higher than expected fuel subsidy burden and regulatory risk in its core transmission business are the key risks for the company.
- Despite the subsidy burden, the strong growth visibility in its core gas transmission business would drive its earnings growth of 12% CAGR during FY10-13.
- At the current market price, the stock trades at a price/earnings ratio of 12.8x and EV/EBITDA of 8.4x based on our FY13 estimates. We have a Buy recommendation on the stock with a price target of Rs567.

| Name | CMP | PER (x) | | | RoE (%) | | | Target | Upside |
|---|---|---|---|---|---|---|---|---|---|
| | (Rs) | FY11 | FY12E | FY13E | FY11 | FY12E | FY13E | price | (%) |
| Godrej Consumer | 432 | 29.0 | 24.3 | 20.6 | 34.6 | 28.5 | 27.6 | 462 | 7 |

**Remarks:**

- Godrej Consumer Products Ltd (GCPL) is a major player in the Indian FMCG market with a strong presence in the personal care, hair care and home care segments in India. The recent acquisitions (in line with the 3x3 strategy) have immensely improved the long-term growth prospects of the company.
- On the back of strong distribution and advertising & promotional support, we expect GCPL to sustain the market share in its core categories of soap and hair colour in the domestic market. On the other hand, continuing its strong growth momentum the household insecticide business is expected to grow by 19% YoY.
- In the international markets, the Indonesian and Argentine businesses are expected to achieve a CAGR of around 25% and 15% respectively over FY11-13. Overall, we expect GCPL's consolidated revenues to grow at a CAGR of about 19% over FY11-13.
- Due to the recent domestic and international acquisitions, the company's business has transformed from a commodities soap business into the business of value-added personal care and home care products. Hence, we expect its OPM to sustain at around 18% in the coming years. Overall, we expect GCPL's bottom line to grow at a CAGR of about 20% over FY11-13.
- We believe increased competitive activity in the personal care and hair care segments and the impact of high food inflation on the demand for its products are the key risks to the company's profitability.
- At the current market price the stock trades at 24.3x its FY12E EPS of Rs17.8 and 20.6x its FY13E EPS of Rs21.0. We have a Buy recommendation on the stock.

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| HCL Tech | 495 | 20.4 | 15.2 | 11.9 | 24.8 | 27.8 | 29.2 | 622 | 26 |

**Remarks:**

- HCL Technologies Ltd (HCL Tech) is a global information technology (IT) services company providing software-led IT solutions, remote infrastructure management services and BPO services. The company has a leading position in remote infrastructure management services which has helped it win large IT outsourcing contracts. Through the Axon plc acquisition the company has gained strong SAP consulting footing.
- Over the last five quarters it has outperformed its peers in terms of volume growth, with an average volume growth of 7.3% during the period. The growth has been broad based across industry verticals, geographies and service lines.
- Going forward, we believe that HCL Tech would outperform its peers in terms of earnings growth with an earnings CAGR of 31% over FY11-13E. On the other hand, further consistency in quarterly performance and improvement in cash generation profile will help gain further investors' confidence in the stock.
- We value HCL Tech at a 25% discount to Infosys at 15x FY13E earnings. At the current market price the stock trades at 15.2x and 11.9x its FY12E and FY13E earnings respectively. We have a Buy recommendation on the stock with price target of Rs622.

| Name | CMP (Rs) | PER (x) | | | RoE (%) | | | Target price | Upside (%) |
|---|---|---|---|---|---|---|---|---|---|
| | | FY11 | FY12E | FY13E | FY11 | FY12E | FY13E | | |
| ITC | **202** | 31.3 | 25.7 | 21.7 | 33.2 | 34.5 | 33.4 | **223** | 11 |

**Remarks:**

- Its cigarette business, which dominates the category, continues to be a cash cow for ITC. The company endeavours to make a mark in the Indian FMCG market and with successful brands such as Bingo, Sunfeast and Aashirwaad, ITC is already in the reckoning among the best in the industry. With the new portfolio of personal care products gaining market share, its FMCG business promises to compete with the likes of Hindustan Unilever and Procter & Gamble.
- After a sharp increase of 16% in Union Budget FY10-11, the government has spared cigarettes from an excise duty hike in the FY2012 budget. Also key states including (Kerala, Karnataka, Andhra Pradesh and Maharashtra) have kept VAT on cigarette unchanged in their respective state budgets. We expect ITC's cigarette sales volume to grow at mid single digits in FY12.
- ITC' other businesses, such as hotel, agri, non-cigarette FMCG business and paper, paperboard and packaging, are showing a strong up-move and will provide a cushion to the overall profit in FY11.
- An increase in taxation and the government's intention to curb the consumption of tobacco products remain the key risks to ITC's cigarette business over the longer term.
- We expect ITC's bottom line to grow at a CAGR of about 20% over FY11-13. At the current market price, the stock trades at 25.7x its FY12E earnings and 21.7x its FY13E earnings. We maintain our Buy recommendation on the stock.

| Name | CMP (Rs) | PER FY11 | PER FY12E | PER FY13E | RoE FY11 | RoE FY12E | RoE FY13E | Target price | Upside (%) |
|---|---|---|---|---|---|---|---|---|---|
| ITNL | **216** | 9.6 | 8.8 | 7.3 | 23.0 | 18.1 | 16.9 | **383** | 78 |

**Remarks:**

- IL&FS Transportation Networks Ltd (ITNL) is India's largest player in the BOT road segment with 10,269 lane km in various stages of development, construction or operation. It has a pan-India presence and a diverse project portfolio consisting of 23 road projects, bus transportation and a metro rail project.
- It is well equipped to capitalise on the huge and growing opportunity in the road infrastructure sector due to its established track record in operating BOT road projects, its execution capabilities and the strong support from IL&FS.
- It has a fair mix of annuity and toll projects in its portfolio which provides revenue comfort. Further, it is present across the value chain except the civil construction services which it outsources to the local contractors. This helps the company to handle a large number of projects at a time and diversify geographically, reducing the risk of concentration.
- Thus, we expect the sales and the earnings to grow at a CAGR of 34.2% and 14.7% respectively over FY11-13E.
- At the current market price, the stock is trading at 8.8x and 7.3x its FY12 and FY13 estimated earnings respectively. We maintain our Buy recommendation with a price target of Rs383.

| Name | CMP (Rs) | PER (x) | | | RoE (%) | | | Target price | Upside (%) |
|---|---|---|---|---|---|---|---|---|---|
| | | FY11 | FY12E | FY13E | FY11 | FY12E | FY13E | | |
| Lupin | **449** | 23.2 | 20.5 | 16.7 | 26.3 | 22.8 | 21.6 | **520** | 16 |

**Remarks:**

- Global dominance in certain products, focus on niche, less-commoditised products, a geographically diversified presence in markets such as Japan and a presence in the US branded segment distinguish Lupin among the mid-cap players in the generic space.
- In FY12, Lupin expects to launch 12 products with at least four in niche therapies, like oral contraceptives in the USA. Along with a strong presence in the branded space through Suprax and Aerochamber, Antara has enabled Lupin's US business to grow at a staggering CAGR of 65% over FY06-10. With the expansion in the branded portfolio through the anticipated launch of Allernaze we expect the US business to grow at a CAGR of 19% over FY11-13. We expect the branded business to contribute about 30% of the total US sales over the next two years.
- With the strong core business and aggressive abbreviated new drug application (ANDA) filings (cumulative 148 ANDA filings till date), a differentiated strategy augurs well for Lupin. Niche product launches like generic Geodon, Fortamet ER, Cipro and OCs would drive upwards performance of the stock.
- Potential delays in the US Food and Drug Administration approval for oral contraceptives and its other niche filings, and ramp-up delays in AllerNaze (expected launch in FY12) are the key challenges for Lupin.
- We expect Lupin to report an earnings CAGR of 18% over FY11-13 with strong margins at the operating level.

| Name | CMP (Rs) | PER FY11 | PER FY12E | PER FY13E | RoE FY11 | RoE FY12E | RoE FY13E | Target price | Upside (%) |
|---|---|---|---|---|---|---|---|---|---|
| M&M | **691** | 16.5 | 15.9 | 13.9 | 22.9 | 22.0 | 21.3 | **735** | 6 |

**Remarks:**

- M&M is a strong rural India story benefited by rising agriculture incomes. The farm equipment sector is estimated to grow by 11-13% in FY12 due to an expectation of better monsoon and greater need for farm mechanisation following labour shortages.
- Automotive sector is expected to grow by 12-15% in FY12. The new sports utility vehicle (SUV) stated to be launched in H2FY11 as well as the existing utility vehicles (UVs) + pick-ups portfolio are expected to deliver a good volume growth for the year.
- The company is expecting partial roll-back of the Maharashtra VAT reversal decision shortly. While negatives have been factored in, any decision on the roll-back by the government will be positive for the company.
- Launches expected in FY12: new SUV, Reva electric NXR, M&M-Navistar trucks and SsangYong SUVs in India.
- Our sum-of-the-parts (SOTP) based price target for M&M is Rs735 per share as we value the core business at Rs599 a share and the subsidiaries are valued at Rs136 a share. We recommend Buy on the stock.

| Name | CMP | PER (x) | | | RoE (%) | | | Target | Upside |
|---|---|---|---|---|---|---|---|---|---|
| | (Rs) | FY11 | FY12E | FY13E | FY11 | FY12E | FY13E | price | (%) |
| PTC India | 79 | 16.7 | 15.3 | 11.2 | 6.2 | 6.7 | 8.7 | 114 | 45 |

**Remarks:**

- PTC India is the leading power trading company in India with market share of around 33% in CY10. Trading volume growth is secured by entering into long-term power purchase agreements (PPA) with power developers. We also expect short-term trading volumes to grow at a CAGR of 20% over FY11-13, driven by the rising power generation capacity and rising merchant power capacity. Also, better penetration of the power exchanges would help in boosting the short-term trading market. Overall, the trading volume is estimated to grow at a CAGR of 34.4% over FY11-13.
- CERC had earlier fixed a short-term trading margin of 4 paise per unit in 2006. In January 2010, CERC revised the short-term trading margins at a maximum of 7 paise per unit while keeping the base rate at 4 paise per unit. This was a positive move for the power trading firms which were reeling under cost pressure.
- Driven by an exponential growth in its traded volumes and an uptick in the trading margins, we expect the non-operational contribution to PBT to fall down from 56% in FY10 to 20% in FY13. We feel that accordingly the core RoE would also improve.
- The company is estimated to show a robust growth in its earnings over the next few years. In the last few years, the company has also made substantial investment in various areas like power project financing via PFS or taking direct equity stake, coal trading and power tolling which have great growth potential in the future. Given its niche positioning, de-risked business model and strong growth outlook with improving core RoE, the valuations are quite attractive on a sum-of-the-parts basis.

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