Sharekhan top picks

After a breather in June 2009 the markets resumed their upward journey in July 2009 with the Sensex and the Nifty gaining 10.5% and 10.1% respectively. Better than expected first quarter results and positive global cues improved the overall sentiments at the domestic bourses last month. Our portfolio of top picks outperformed the benchmark indices by giving a return of 15.4% led by smart outperformance by consumer goods stocks, Godrej Consumer Products, ITC and Balrampur Chini Mills (the latter two were added in the last month). Apart from the consumer stocks, Shiv-Vani Oil and Gas Exploration Services (Shiv-Vani) was the top performer in the top picks basket with a stupendous return of 32.6% for the month.

In the current top picks basket, three stocks, Unity Infraprojects, Shiv-Vani and 3i infotech, have generated handsome returns of 171%, 100% and 49% respectively since their inclusion in May 2009. We advise taking some profits home, especially since some of these stocks are trading close to their fair value and could underperform the market in the near term. Thus, we remove these stocks from the portfolio.

For August 2009, there are only two new additions (instead of three) to the portfolio, as we are inclined to have more cash in the kitty to avail of any good investment opportunity that may present itself during the month. We add Emco India and Apollo Tyres. In line with our positive view on power transmission and distribution sector, we have added Emco India to the list of the top picks. We are also bullish on Apollo Tyres due to its strong positioning in the tyre replacement market, the revival in the demand for tyres from the original equipment manufacturers and the hefty improvement in the profitability of the company due to the steep reduction in raw material cost that would result in a strong earning growth going ahead.

Name	CMP* (Rs)	PER (x)			RoE (%)			Target price	Upside (%)
		FY09	FY10E	FY11E	FY09	FY10E	FY11E		
Apollo Tyres	42	20.0	6.5	6.0	7.9	19.9	17.9	53	26.2
Bajaj Holdings	470	21.6	-	-	-	-	-	810	72.4
Balrampur Chini	120	13.6	10.4	9.7	20.7	22.6	20.3	148	23.2
Bharti Airtel	399	17.9	15.1	13.2	30.3	26.7	24.4	453	13.4
Bharat Heavy Electricals	2,273	35.5	25.1	19.5	23.8	26.6	27.0	2,335	2.7
Emco	84	9.3	8.0	6.6	12.1	12.5	13.8	115	37.1
Godrej Consumer	216	32.2	22.7	20.0	46.9	38.8	36.1	240	11.1
ITC	234	27.2	23.0	19.8	25.3	25.8	25.1	248	5.9
Lupin	937	15.7	13.4	11.5	31.9	24.4	23.1	978	4.4
Reliance Industries	2,047	20.6	17.2	13.4	13.2	14.5	15.8	**	-

* CMP as on August 06, 2009 **Price target under review

Name	CMP	PER			RoE (%)			Target	Upside
	(Rs)	FY09	FY10E	FY11E	FY09	FY10E	FY11E	price	(%)
Apollo Tyres	**42**	20.0	6.5	6.0	7.9	19.9	17.9	**53**	26.2

Remarks:

- Apollo Tyres Ltd (APL) is the market leader in truck & bus tyres and light truck tyres in India. The company also enjoys significant market share in the passenger car tyre segment. While the improving demand in replacement and OEM markets augurs well for the top line growth, much lower rubber prices will help APL post 3x jump in the net profit in FY2010 from domestic operations.
- To improve its market share and expand further the company is increasing its capacity in India from 850 tonne per day to around 1,000 tonne per day by establishing a new greenfield plant in Chennai. In international markets APL has presence in South Africa, and to further augment its international presence the company has recently acquired Vredestein Banden BV, a high-end passenger car tyre manufacturer in Netherlands. We believe the above organic and inorganic expansions coupled with improving business environment in the domestic market would help the company post strong growth in the coming years.
- We believe the key risks for APL lie in any sharp upward movement in rubber prices and crude derivatives used as inputs. Also, the near-term performance of the recently acquired European business is susceptible to difficult business environment in these markets.
- At the current market price the stock trades at 6.5x and 6x (its stand-alone) FY2010E and FY2011E earnings respectively. We maintain our Buy recommendation on the stock.

Bajaj Holdings	**470**	21.6	-	-	-	-	-	**810**	72.4

Remarks:

- Bajaj Holdings & Investments Ltd (BHIL) was created by de-merging Bajaj Auto and the company primarily functions in investment space. The company is also on a lookout for new business opportunities.
- BHIL holds Rahul Bajaj Group's strategic investments in Bajaj Auto, Bajaj Finserv, Bajaj Auto Holdings and Maharashtra Scooters. It also looks into other investments in equity markets and government securities, bonds, debentures and mutual funds.
- We value BHIL based on our price target for Bajaj Auto, Bajaj Finserv and other investments at market value and give the holding company a discount of 50% for the same. Moreover, we add the value of its cash and liquid investments, which gives us a fair value of Rs810 for the stock, which is substantially above its current market price of Rs471.
- Further, zero-debt status of the company makes the stock attractive. We therefore maintain Buy recommendation on the stock.

Balrampur Chini	**120**	13.6	10.4	9.7	20.7	22.6	20.3	**148**	23.2

Remarks:

- Balrampur Chini Mills Ltd (BCML) is the second largest sugar manufacturer in India. With distillery and power cogeneration units, its facilities are fully integrated, which apart from ensuring efficient use of the by-products also provide a steady stream of revenues that enables the company to perform better even in a sugar downcycle.
- BCML is expected to be a key beneficiary of the current bull phase in the sugar cycle and we expect it to report a CAGR of 59.2% in its net profit over FY2008-11.
- The key risk for the company and the other Uttar Pradesh-based sugar mills remains the declaration of a higher than expected SMP for sugar-cane, as this may lead to an increase in the sugar-cane price paid to the farmers and thus affect the profitability of the sugar mills.
- At the current market price the stock trades at a PE of 9.7x and EV/EBIDTA of 6.1x FY2011E (ending September 2011). We maintain our Buy recommendation on the stock.

Name	CMP	PER			RoE (%)			Target	Upside
	(Rs)	FY09	FY10E	FY11E	FY09	FY10E	FY11E	price	(%)
Bharti Airtel	**399**	17.9	15.1	13.2	30.3	26.7	24.4	**453**	13.4

Remarks:

- Bharti Airtel (Bharti) with over 24% market share is a leader in the Indian telecom space. On an average, the company has been adding around 2.8 million subscribers every month and its subscriber base has now crossed the 100 million mark.
- Despite the competition-led pricing pressures, Bharti has been able to sustain its operating margins at 42% on the back of strong growth in subscribers.
- We expect Bharti to maintain the momentum in the net subscriber additions despite the highly competitive environment. Moreover, a less-than-expected fall in the average revenue per user should lead to a stronger operating performance.
- With the entry of Reliance Communications in the GSM market, the competition is expected to increase, which could pressurise the margins. The uncertainty and aggressive bidding in 3G auctions are the risks, which could impact the cash flows of the company.
- At the current market price the stock trades at 15.1x FY2010 and 13.2x FY2011 estimated earnings.

Name	CMP	PER FY09	PER FY10E	PER FY11E	RoE FY09	RoE FY10E	RoE FY11E	Target price	Upside (%)
BHEL	**2,273**	35.5	25.1	19.5	23.8	26.6	27.0	**2,335**	2.7

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 Rs124,000 crore on hand, which provides revenue coverage for the next three to four years. With more than 80% of the orders coming from the government and state utilities, the risk of order cancellation is minimal.
- The company would also be awarded five or six sets of 800MW supercritical technology based units from National Thermal Power Corporation (NTPC) on a negotiated basis. We believe the order inflow momentum would continue to remain strong for the company.
- At the beginning of 2008, the company brought on-stream 4GW of additional manufacturing capacity, taking its total capacity to 10GW per annum. In our view, the stabilisation of the new capacity coupled with the de-bottlenecking of the supply chain would aid BHEL's revenues to grow at a CAGR of 25.9% over FY2009-11E. We estimate the profits to grow at a CAGR of 35% over FY2009-11E. However, the key challenge for BHEL would be the timely execution of projects.
- We have a Hold recommendation on BHEL mainly because at the current valuation of 19.5x our FY2011 earnings per share estimate (the valuation is at a substantial premium to that of the Sensex) the stock price is closer to our fair value for the stock. However, we continue to like BHEL because of its resilient business model that is expected to provide the highest revenue and profit growth among the Sensex stocks. We, therefore, maintain BHEL amongst our Top Picks with a price target of 2,335.

Name	CMP	PER FY09	PER FY10E	PER FY11E	RoE FY09	RoE FY10E	RoE FY11E	Target price	Upside (%)
Emco	**84**	9.3	8.0	6.6	12.1	12.5	13.8	**115**	37.1

Remarks:

- Emco is a leading player in the domestic power transmission and distribution (T&D) space and is fast emerging as an end-to-end solution provider in the space. The company offers the widest range of transformers in the country.
- The current order backlog stands at Rs1,505 crore (1.42x FY2009 revenues) imparting visibility to the earnings going forward. Furthermore, with close to 70% of the orders coming from government companies (state electricity boards and public sector undertakings) the risk of order cancellation and delay is lower.
- We believe the order pipeline would continue to be robust for Emco on the back of increased governmental thrust on power T&D spending.
- Key risks to the company are slower-than-expected execution of orders and slower order inflow.
- We expect Emco's revenue and profit to witness a compounded annual growth rate of 18.7% and 25.3% over FY2009-11E. At the current market price the stock trades at 8x and 6.6x FY2010 and FY2011 fully diluted earnings per share (EPS) respectively. We recommend Buy on the stock with the price target of Rs115.

Name	CMP	PER			RoE (%)			Target	Upside
	(Rs)	FY09	FY10E	FY11E	FY09	FY10E	FY11E	price	(%)
Godrej Consumer	**216**	32.2	22.7	20.0	46.9	38.8	36.1	**240**	11.1

Remarks:

- GCPL is a major player in the Indian fast moving consumer goods (FMCG) market with presence in soap, hair dye and hair colour, liquid detergent and toiletries categories. With rural demand remaining strong and the ongoing downturn keeping the demand for FMCG products buoyant at the bottom of the pyramid, GCPL's soap portfolio, which contributes more than half of its annual revenues, will outperform the industry in terms of volume growth. Thus we expect GCPL's top line to grow at CAGR of 15.3% over FY2009-11.
- With the steep correction in the palm oil prices (the key raw material), we expect the margins of the company to substantially improve and result in a hefty growth of 35% yoy in its net profit in FY2010.
- With strong cash flows and healthy cash on books (Rs400 crore as on March 31, 2009), GCPL is well funded to make acquisitions in both domestic and international markets which we believe could act as additional triggers for the stock.
- We see impact of the recession on GCPL's business in the UK as a key concern, also on the domestic front deficient monsoons and its impact on rural incomes could slowdown the growth momentum for GCPL.
- With a 26.5% CAGR over FY2009-11 it will outperform the industry and remain one of the better performing companies in the FMCG space. At the current market price the stock trades at a valuation of 20x its FY2011E earnings (excluding Sara Lee acquisition). We maintain our Hold recommendation on the stock.

Name	CMP	PER FY09	PER FY10E	PER FY11E	RoE FY09	RoE FY10E	RoE FY11E	Target price	Upside (%)
ITC	**234**	27.2	23.0	19.8	25.3	25.8	25.1	**248**	5.9

Remarks:

- ITC's cigarette business that has dominance in the category continues to be a cash cow for the company. ITC has chalked out an aggressive roadmap for making a mark in the Indian FMCG market with successful brands such as *Bingo*, *Sunfeast* and *Aashirwaad* already in the reckoning among the best in the industry. The company has further ventured into the personal care category with the launch of *Superia* and *Fiama Di Wills* soaps and shampoos that would compete with the likes of products from HUL and Procter & Gamble.
- After a sharp increase in the excise duty on cigarettes in the last two union budgets, the government was less lethal in the FY2009-10 union budget and did not increase the excise duty. This augurs well for ITC's cigarette business. Further, the sharp correction in the raw material prices, rationalisation of the company's biscuit portfolio and an increase in the scale of its personal care business would lower the losses in the non-cigarette FMCG business in FY2010.
- An increase in taxation and the government's intentions to curb consumption of tobacco products remain the key risks to ITC's cigarette business over the longer term.
- We expect ITC's top line to grow at a CAGR of 13.6% and its bottom line to grow at a CAGR of 16.9% over FY2009-11. At the current market price, ITC trades at 19.8x its FY2011E earnings. We maintain our Hold recommendation on the stock.

Name	CMP	PER FY09	PER FY10E	PER FY11E	RoE FY09	RoE FY10E	RoE FY11E	Target price	Upside (%)
Lupin	**937**	15.7	13.4	11.5	31.9	24.4	23.1	**978**	4.4

Remarks:

- Global dominance in certain products, focus on niche less-commoditised products, a geographically diversified presence in newer markets such as Japan and a presence in the US branded segment distinguish Lupin among the mid-cap players in the generic space.
- With a leadership position in the anti-TB and other anti-infective segments and growing exposure to the chronic therapy segments, Lupin is one of the fastest growing pharmaceutical companies in the domestic market.
- A focus on niche products like injectable cephalosporins along with presence in the branded space through a pediatric antibiotic, Suprax, has enabled Lupin's US business to grow at a staggering CAGR of 78% over FY2004-09.
- With a strong business in India and the USA, Lupin has also made inroads into the other regulated markets of the UK and France. Further, it has entered markets like Japan, Germany, Australia and South Africa through acquisitions in order to extend its global reach.
- Even though the core business remains strong, the warning letter from the US Food and Drug Administration relating to its Manindeep facility could weigh on the valuations in the near term performance of its stock.
- At 13.4x FY2010E and 11.5x FY2011E earnings, Lupin is among the cheapest front-line pharmaceutical stocks. We maintain our Buy recommendation on the stock with a price target of Rs978.

Name	CMP	PER			RoE (%)			Target	Upside
	(Rs)	FY09	FY10E	FY11E	FY09	FY10E	FY11E	price	(%)
Reliance Industries	2,047	20.6	17.2	13.4	13.2	14.5	15.8	**	-

Remarks:

- With the start of commercial production of gas in April 2009 and that of crude oil in September 2008 (both from KG basin), Reliance Industries Ltd (RIL) holds a great promise in the E&P business. The E&P business is expected to add significantly to the company's earnings and cash flow from FY2010 onwards with majority of the earnings coming from the less volatile natural gas business. The gas production will begin in small tranches initially and is expected to 80mmscmd by the end of 2009. At present, the company's reserves are estimated at 9 billion barrels of oil equivalents.
- We expect the gross refining margin (GRM) of RIL to contract in the near to medium term, as new refineries with total capacity of 1.5-2.0 million barrel per day (including Reliance Petroleum Ltd [RPL]) are expected to come on-stream in 2009 in the environment of weak demand. However, we expect RIL to fetch a premium over Singapore Complex' GRM due to its superior refinery complexity. The refining volumes would also double as RPL's refinery became operational on December 25, 2008.
- We believe that RIL would be bale to maintain superior margin in the petrochemical business given its increased focus on the domestic market (strong demand and high price realisation environment).
- A delay in the ramp-up of KG D-6 gas production and an adverse verdict of the Supreme Court of India on its legal feud with RNRL and another legal case with NTPC are the key risks to our estimates. Furthermore, there is still ambiguity related to the likely change in the section 80IB, which could take away the benefit of the seven-year tax holiday from the gas production. Any further fall in the refining and petrochemical margins could result in deviation from our estimates.
- At the current market price, the stock is trading at 13.4x FY2011E consolidated earnings.

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