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Change in recommendations

BHEL: Powered by strong order inflows revise target price and upgrade rating

Tata Steel: Raise to In-Line; but, we won't turn buyers just yet

EQUITY MARKETS

India	Change, %			
	17-Aug	1-day	1-mo	3-mo
Sensex	14,142	(1.5)	(9.1)	(1.1)
Nifty	4,108	(1.7)	(10.0)	(2.5)
Global/Regional indices				
Dow Jones	13,079	1.8	(5.6)	(3.5)
Nasdaq Composite	2,505	2.2	(6.8)	(2.1)
FTSE	6,064	3.5	(7.9)	(8.7)
Nikkei	15,837	3.7	(12.8)	(9.0)
Hang Seng	21,020	3.1	(9.8)	0.6
KOSPI	1,713	4.5	(13.7)	6.2
Value traded - India				
		Moving avg, Rs bn		
	17-Aug	1-mo	3-mo	
Cash (NSE+BSE)	218.8	166.7	154.2	
Derivatives (NSE)	648.8	458.3	366.7	
Deri. open interest	870.2	853.3	572.9	

Forex/money market

	Change, basis points			
	17-Aug	1-day	1-mo	3-mo
Rs/US\$	41.3	-	102	68
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	8.0	(2)	18	(18)

Net investment (US\$m)

	16-Aug	MTD	CYTD
FIs	(705)	1,759	9,530
MFs	58	111	(112)

Top movers -3mo basis

Best performers	Change, %			
	17-Aug	1-day	1-mo	3-mo
Thermax	619	(3.2)	0.2	50.3
Reliance Energy	719	0.3	4.5	40.7
Crompton Greaves	275	(2.8)	4.4	22.2
ABB India	1,025	(3.4)	(4.4)	19.0
BHEL	1,559	(2.7)	(5.4)	19.0
Worst performers				
Polaris	117	(0.9)	(11.2)	(33.0)
Escorts	86	(3.6)	(23.1)	(33.8)
IOC	376	(3.7)	(12.5)	(25.3)
Bharat Forge	261	(1.9)	(14.4)	(22.6)
Raymond	269	(1.1)	(7.7)	(20.8)

News Roundup

Corporate

- Reliance expected to find hydrocarbon prospects in D4 block in KG basin. The company is undertaking a second stage of testing to explore the region. (BL)
- Great Offshore is believed to be acquiring Norwegian offshore company PetroJack in a \$500 mn deal. Aban Offshore has a considerable stake in PetroJack. (ET)
- Essar Steel to invest Rs2 bn to set up three service centres in the country to cater to its clients in the auto and white goods sector (ET)

Economic and political

- Congress sets up expert panel to break the crisis over the nuclear agreement (ET)
- TRAI is expected to recommend removal of cap on the number of players in a circle and allowing operators to offer both GSM and CDMA under the same license (ET)

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

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Industrials**BHEL.BO, Rs1559**

Rating	OP
Sector coverage view	Attractive
Target Price (Rs)	1,825
52W High -Low (Rs)	1899 - 970
Market Cap (Rs bn)	763.1

Financials

March y/e	2007E	2008E	2009E
Sales (Rs bn)	172.4	221.9	268.2
Net Profit (Rs bn)	24.1	31.9	40.4
EPS (Rs)	49.3	65.2	82.4
EPS <i>gth</i>	44.1	32.2	26.4
P/E (x)	31.6	23.9	18.9
EV/EBITDA (x)	17.9	13.6	10.7
Div yield (%)	0.7	0.9	1.2

Shareholding, June 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	67.7	-	-
FIs	19.5	2.1	(0.3)
MFs	5.1	3.2	0.9
UTI	-	-	(2.4)
LIC	1.9	1.1	(1.3)

BHEL: Powered by strong order inflows revise target price and upgrade rating

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- **Order from OBRA thermal power plant with 50% equity stake help kick-start the supercritical technology absorption process**
- **Brisk ordering activity for XIth plan mitigates concerns of missing XIth plan target**
- **Highlight near-term order inflows of about 19,819 MW from remaining XIth plan projects**
- **Revise earnings estimate and target price to Rs1,825 (from Rs1,550 earlier)**
- **Revise rating to Outperform (from Inline earlier), based on recent sharp correction, strong order inflows and execution**

BHEL has received orders for two supercritical units of 800 MW each at OBRA power station. BHEL is also picking up a 50% equity stake in the project, which may have tilted the scales in its favor. Ordering activity for XIth plan requirements is very strong, with BHEL winning orders for 7,850 MW in FY2008 so far. We estimate that BHEL could have near-term order inflows of about 19,819 MW for the XIth plan projects that have not yet been ordered. We revise our estimates and DCF-based target price to Rs1,825/share (from Rs1,550 earlier) and upgrade rating to Outperform (from Inline earlier), based on recent sharp correction, strong order inflows and execution. Key risks arise from increasing competition and changing project profile. We highlight that (a) competition has won projects worth about 4,000 MW over the last two months and (b) XIth plan project profile may pose pressure on growth and margins in the power segment. Key catalysts include award of bulk order for 800MW units from NTPC and continued strong order inflows and execution.

Order from OBRA thermal power plant with 50% equity stake help kick-start the supercritical technology absorption process

BHEL has received an order from UP Power Corporation Limited for two supercritical units of 800 MW each at OBRA power station. BHEL is also picking up a 50% equity stake in the project and this may have tilted the scales in its favor. We believe that this order would help BHEL in kick-starting the technology absorption process for supercritical units and in becoming competitive with global manufacturers over a period of time. We believe that equity investment in the project from BHEL could be to the tune of Rs8.0 bn (50% of Rs16 bn equity in the project at a debt-equity ratio of 75:25). Investing in a project that is likely to earn low returns on equity (of about 14-16%) could dilute the return-on-equity for BHEL (BHEL has RoE of about 30% including cash). However, strategic benefits from such a move far outweighs this concern.

News reports suggest that BHEL may also have won an order from UP Power Corporation for the 1,000 MW Anpara - D project, worth about Rs40 bn.

Brisk ordering activity for XIth plan mitigates concerns of missing XIth plan target

Ordering activity for XIth plan requirements is very strong and BHEL has recently won orders for 7,850 MW in FY2008 so far, including the 1,000 MW order from Sudan (Exhibit 1).

As per our database, out of a total planned capacity addition of about 72,169 MW for the XIth plan, orders have already been placed for about 46,395 MW on equipment suppliers. Thus we believe that achievement could be close to the planned capacity addition in the XIth plan, versus only about 50% achievement in the Xth plan (Exhibit 2).

We expect near-term order inflows of about 19,819 MW for BHEL from remaining XIth plan projects

We estimate that BHEL could have near-term order inflows of about 19,819 MW for the XIth plan projects that have not been ordered yet, based on the market share that BHEL has recorded so far in the XIth plan projects. BHEL had booked orders of about 8,877 MW worth about Rs202bn in FY2007. (Exhibits 2 & 3).

Competition also makes some headway in winning significant orders in India

We highlight that competition has also made some headway in winning power projects in India. Over the last two months orders for about 4,000 MW (worth about Rs139 bn) have gone to competition. We believe that CEA allows project configuration to be kept flexible and currently bids are invited for flexible 250/300 MW and 500/600 MW configurations. Thus, if a bid is invited for flexible configuration of either 500 or 600 MW, then the 600 MW bidder has an advantage over the bidder with 500 MW configuration, because per MW cost is lower for 600MW configuration bid. This may have led to BHEL bid being slightly uncompetitive versus competition in these projects or BHEL may have stayed away from bidding. Perception that BHEL is fully booked and there may be delays in deliveries of critical power equipment may also have catalyzed the loss of these orders (Exhibit 4).

Highlight that XIIth plan project profile, total execution requirements may pose pressure on growth in the power segment

We estimate a capacity addition requirement of about 90,000 MW in the XIIth plan and execution of about 53,000 MW by BHEL in the XIIth plan (Exhibits 6 & 7). Thus overall growth in the power segment in the XIIth plan, over execution of 44,000 MW in the XIth plan, is likely to be muted. Further, if larger proportion of capacity addition happens through (a) ultra-mega power projects, (b) tariff-based competitive bidding for state level projects, (c) gas-based projects in the private sector with increasing gas availability, then BHEL's overall market share of the overall capacity addition may also be under pressure. However growth in industry segment and exports could surprise on the upside.

Revise earnings estimate and target price to Rs1,825 (from Rs1,550 earlier)

We revise our execution estimate in XIth plan from 41,250 MW earlier to 44,000 MW now based on strong order wins for BHEL. We revise our earnings estimate for FY2008E and FY2009E to Rs65.9 (from Rs61.4 earlier) and Rs82.4 (from Rs74.2 earlier).

Our earnings revision is based on (a) higher execution assumption in the XIth plan (44,000 MW now) versus 41,250 MW earlier, (b) higher other income and (c) higher provisions related to wage revision than we had projected earlier.

We revise our DCF based target price to Rs1,825 from Rs1,550 earlier. Our key DCF assumptions are

- a) execution of 44,000 MW and 53,000 MW in the XIth and XIIth plans respectively,
- b) realization of Rs26 mn/MW and Rs30 mn/MW in the XIth plan and XIIth plan respectively (may be affected by mix of orders i.e. for BTG package or complete EPC contract. In FY2007 BHEL booked orders for 8,877 MW for a total order value of Rs202 bn, i.e. Rs22.8 mn/MW)
- c) industry sector CAGR growth of 20% in the XIth plan and 16% in the XIIth plan, higher than our earlier estimate (Exhibit 8).

Revise rating to Outperform from In-line earlier based on recent correction and upside to our DCF based target price

We rate the stock outperform (from In-line earlier), based on sharp 16% correction over the last one month as well as 17% upside to our revised target price.

Key catalysts for the stock include (a) continued strong order inflows and execution, (b) order from the Krishnapatnam project (supercritical unit of 800 MW) and (c) orders from NTPC for its bulk requirements for North Karanpura, Barh, Lara and Darlipala projects (Exhibit 9).

Exhibit 1: Brisk ordering activity in XIth Plan ensures strong order inflows for BHEL

Recent orders won by BHEL

Customer/Project	Project/Location	Capacity (MW)	Configuration	Contract value (Rs bn)	Scope of work
Sudan	Sudan	1,000	2X 500 MW	40	EPC Contract
UP Power Corporation Ltd.	OBRA	1,600	2X 800 MW	64	EPC Contract
UP Power Corporation Ltd.	Anpara - D	1,000	2X 500 MW	40	EPC Contract
Gujarat State Electricity Corporation Ltd.	Sikka	540	540 MW	20	EPC Contract
Damodar Valley Corporation	Koderma	1,000	2X 500 MW	33	EPC Contract
Maheshwar Hydro Electric Power Project	Madhya Pradesh	400	400 MW	6	Electromechanical component
APGENCO	Rayalseema	210	210 MW	6	EPC Contract
GVK Power and Infrastructure	Srinagar hydro power project	330	330 MW	4	Electromechanical component
National Hydro Power Corporation	Teesta	270	270 MW	3	Electromechanical component
Haryana Power Generation Corporation Ltd.	Jhajjar, Haryana	1,500	3 X 500 MW	19	Equipment supply
Total		7850 MW		235	

Source: News reports, Kotak Institutional Equities estimates.

Exhibit 2: We expect achievement in the XIth plan to be close to planned capacity addition, given that equipment orders have been placed for large proportion of planned capacity

Summary of XIth plan projects and projects for which power equipment orders have been placed already

Total projects in the XIth plan

Centre	Thermal			Gas	Hydro	Nuclear	Total
	Coal		Total				
	Supercritical	Subcritical					
NTPC	6,600	17,660	24,260	750	9,685	3,160	37,855
NHPC	6,600	9,460	16,060	-	1,920	-	17,980
DVC	-	-	-	-	4,833	-	4,833
Others	-	6,200	6,200	-	-	-	6,200
State	-	2,000	2,000	750	2,932	3,160	8,842
State	2,400	18,440	20,840	612	2,637	-	24,089
Private	660	5,550	6,210	752	3,263	-	10,225
Total	9,660	41,650	51,310	2,114	15,585	3,160	72,169

Projects in the XIth plan - Under construction

Centre	Thermal			Gas	Hydro	Nuclear	Total
	Coal		Total				
	Supercritical	Subcritical					
NTPC	3,960	8,430	12,390	-	7,633	3,160	23,183
NHPC	3,960	3,980	7,940	-	1,400	-	9,340
DVC	-	-	-	-	4,713	-	4,713
Others	-	3,700	3,700	-	-	-	3,700
State	-	750	750	-	1,520	3,160	5,430
State	1,600	11,190	12,790	262	2,107	-	15,159
Private	660	4,450	5,110	752	2,191	-	8,053
Total	6,220	24,070	30,290	1,014	11,931	3,160	46,395

Source: Ministry of Power, Kotak Institutional Equities estimates.

Exhibit 3: BHEL has approximately 63% market share out of the XIth plan thermal projects already ordered inspite of losing Barh and Sipat earlier

Summary of XIth plan projects with BHEL having the order

Projects in the XIth plan - Under construction with BHEL having the order

	Thermal			Gas	Hydro	Nuclear	Total
	Coal		Total				
	Supercritical	Subcritical					
Centre	-	7,230	7,230	-	4,000	-	11,230
NTPC	-	3,980	3,980	-	1,400	-	5,380
NHPC	-	-	-	-	1,600	-	1,600
DVC	-	2,500	2,500	-	-	-	2,500
Others	-	750	750	-	1,000	-	1,750
State	1,600	8,990	10,590	170	473	-	11,233
Private	-	1,250	1,250	-	1,022	-	2,272
Total	1,600	17,470	19,070	170	5,495	-	24,735

Projects in the XIth plan - BHEL's market share for under construction projects

	Thermal			Gas	Hydro	Nuclear	Total
	Coal		Total				
	Supercritical	Subcritical					
Centre	-	86	58	-	52	-	48
NTPC	-	100	50	-	100	-	58
NHPC	-	-	-	-	34	-	34
DVC	-	68	68	-	-	-	68
Others	-	100	100	-	66	-	32
State	100	80	83	65	22	-	74
Private	-	28	24	-	47	-	28
Total	-	73	63	17	46	-	53

Source: Ministry of Power, Kotak Institutional Equities estimates.

Exhibit 4: Analysis of XIth plan suggest strong near term order inflows of c.20,000 MW

Analysis of BHEL's prospects for the remaining projects to be ordered in the XIth plan

Projects in the XIth plan - To be ordered

	Thermal			Gas	Hydro	Nuclear	Total
	Coal		Total				
	Supercritical	Subcritical					
Centre	2,640	9,230	11,870	750	2,052	-	14,672
NTPC	2,640	5,480	8,120	-	520	-	8,640
NHPC	-	-	-	-	120	-	120
DVC	-	2,500	2,500	-	-	-	2,500
Others	-	1,250	1,250	750	1,412	-	3,412
State	800	7,250	8,050	350	530	-	8,930
Private	-	1,100	1,100	-	1,072	-	2,172
Total	3,440	17,580	21,020	1,100	3,654	-	25,774

Potential orders for BHEL out of the remaining projects in the XIth plan

	Thermal			Gas	Hydro	Nuclear	Total
	Coal		Total				
	Supercritical	Subcritical					
Centre	1,320	9,230	10,550	-	1,490	-	12,040
NTPC	1,320	5,480	6,800	-	520	-	7,320
NHPC	-	-	-	-	41	-	41
DVC	-	2,500	2,500	-	-	-	2,500
Others	-	1,250	1,250	-	929	-	2,179
State	800	5,825	6,625	227	119	-	6,971
Private	-	309	309	-	500	-	809
Total	2,120	15,364	17,484	227	2,109	-	19,819

Source: Ministry of Power, Kotak Institutional Equities estimates.

Exhibit 5: Competition has made some inroads in the Indian power equipment market

List of orders lost by BHEL in recent times

Winner/EPC Contractor	Customer/Project	Project/Location	Capacity (MW)	Configuration	Contract value (Rs bn)	Potential equipment supplier
China National Machinery and Export Company (CMEC)	Chattisgarh State Electricity Board	Korba West III, Chattisgarh	600	2X 300 MW	22	Harbin Power Equipment Company, China
Reliance Energy	Damodar Valley Corporation	Purulia (West Bengal)	1,200	2X 600 MW	40	Shanghai Electric Corporation, China
Reliance Energy	Haryana Power Generation Corporation Ltd	Hissar (Haryana)	1,200	4X 300 MW	43	Shanghai Electric Corporation, China
Ranhill Engineers and Constructors Sdn Bhd	Dheeru Powergen Pvt. Ltd (promoted by Ranhill)	Korba, Chhattisgarh	700	2X350 MW	24	N.A
Ranhill Engineers and Constructors Sdn Bhd and Ranhill (India) Pte Ltd	KVK Nilachal Power	Cuttack, Orrissa	300	300 MW	10	N.A.
Total			4,000 MW		139	

Source: News reports, Kotak Institutional Equities estimates.

Exhibit 6: XIIth plan would require capacity addition of about 90,000 MW

Estimate of required generation capacity addition in the XIIth plan

Estimated generation capacity at the end of XIth plan (MW)	200,000
Estimated GDP growth rate FY20013-17 (%)	8.5
GDP growth/ Electricity elasticity (X)	0.9
Required generation capacity, CAGR growth (%)	7.7
Generation capacity required to be set up (MW)	89,135

Source: Ministry of Power, Kotak Institutional Equities estimates.

Exhibit 7: We estimate an execution of 92,604 MW in the XIIth plan and expect BHEL to do about 54,119 MW out of this

Analysis of XIIth plan projects and BHEL's prospects for the XIIth plan (MW)

Total projects on the shelf for the XIIth plan

	Thermal			Gas	Hydro	Nuclear	Total
	Coal		Total				
	Supercritical	Subcritical					
Centre	7,860	7,190	15,050	4,550	23,931	12,800	56,331
NTPC	7,860	250	8,110	4,550	5,051	2,000	19,711
NHPC	-	-	-	-	11,899	-	11,899
DVC	-	1,500	1,500	-	-	-	1,500
Others	-	5,440	5,440	-	6,981	10,800	23,221
State	800	33,760	34,560	2,370	8,349	-	45,279
Private	6,520	7,005	13,525	8,663	8,378	-	30,566
Ultra mega power projects	35,300	-	35,300	-	-	-	35,300
Total	15,180	47,955	98,435	15,583	40,658	12,800	167,476

Total projects in the XIIth plan - Likely to be taken up for commissioning

	Thermal			Gas	Hydro	Nuclear	Total
	Coal		Total				
	Supercritical	Subcritical					
Centre	5,502	4,564	10,066	3,413	11,520	8,020	33,018
NTPC	5,502	250	5,752	3,413	2,778	1,000	12,943
NHPC	-	-	-	-	5,950	-	5,950
DVC	-	1,050	1,050	-	-	-	1,050
Others	-	3,264	3,264	-	2,792	7,020	13,076
State	800	20,256	21,056	1,422	4,174	-	26,652
Private	3,260	3,503	6,763	4,332	4,189	-	15,283
Ultra mega power projects	17,650	-	17,650	-	-	-	17,650
Total	27,212	28,323	55,535	9,166	19,883	8,020	92,604

Projects in the XIIth plan - Assumption of BHEL's market share segment wise (%)

	Thermal			Gas	Hydro	Nuclear	Total
	Coal		Total				
	Supercritical	Subcritical					
Centre	90	91	90	100	55	22	62
NTPC	90	100	90	100	80	-	84
NHPC	-	-	-	-	50	-	50
DVC	-	90	90	-	-	-	90
Others	-	90	90	-	40	25	44
State	100	80	81	65	40	-	74
Private	40	50	45	50	40	-	45
Ultra mega power projects	40	-	40	-	-	-	40
Total	52	78	65	71	49	22	58

Total projects in the XIIth plan - BHEL's market share (MW)

	Thermal			Gas	Hydro	Nuclear	Total
	Coal		Total				
	Supercritical	Subcritical					
Centre	4,952	4,133	9,084	3,413	6,314	1,755	20,566
NTPC	4,952	250	5,202	3,413	2,222	-	10,837
NHPC	-	-	-	-	2,975	-	2,975
DVC	-	945	945	-	-	-	945
Others	-	2,938	2,938	-	1,117	1,755	5,810
State	800	16,205	17,005	922	1,670	-	19,597
Private	1,304	1,751	3,055	2,166	1,676	-	6,897
Ultra mega power projects	7,060	-	7,060	-	-	-	7,060
Total	14,116	22,089	36,204	6,501	9,659	1,755	54,119

Source: Kotak Institutional Equities estimates.

Exhibit 8: Our DCF based valuation with favorable assumptions of execution, market
 DCF valuation for BHEL, March fiscal year ends 2008-2018E, (Rs mn)

	FY2003-07	FY2008-12	FY2013-17
Planned capacity addition (in MW)	37,582	72,169	92,604
BHEL's market share		44,000	53,019
a) Power revenues (Rs bn)	434.7	1,144.0	1,590.6
Revenues / MW (Rs mn)		26.0	30.0
b) Industry revenues (Rs bn)	176.0	452.5	911.4
Total revenues	610.7	1,596.5	2,502.0

Plan period year	1	2	3	4	5
Execution pattern over the plan per	15.7	19	20.5	21.3	23.5

Year to March	Existing orders ensure visibility			Further XIth plan order inflows		XII plan execution of 53,019 MW; 35% of revenues from industry sector (16% CAGR growth)					Terminal year
	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E
Revenue	223,667	270,033	296,459	314,734	348,776	392,815	437,851	500,401	557,947	612,991	643,641
Growth (%)	28.6	20.7	9.8	6.2	10.8	12.6	11.5	14.3	11.5	9.9	5.0
EBIT margin	22.5	23.1	16.9	20.6	21.2	19.0	19.0	19.0	19.0	19.0	19.0
EBIT*(1-tax rate)	33,263	41,172	33,065	42,849	48,889	49,259	54,907	62,750	69,967	76,869	80,713
Depreciation	3,038	3,354	3,694	4,034	4,306	4,200	4,200	4,200	4,200	4,200	1,900
Capital expenditure	(4,300)	(5,000)	(5,000)	(5,000)	(3,000)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)
Free Cash Flows	32,000	39,526	31,759	41,883	50,194	51,459	57,107	64,950	72,167	79,069	80,613
Growth (%)	50	24	(20)	32	20	3	11	14	11	10	2
Years discounted	-	-	1	2	3	4	5	6	7	8	9
Discount factor	1.00	1.00	0.89	0.79	0.71	0.63	0.56	0.50	0.45	0.40	0.35
Discounted cash flow	32,000	39,526	28,293	33,240	35,489	32,413	32,045	32,469	32,139	31,370	28,492

Target price calculation	Rs mn
Sum of free cash flow	328,983
Discounted terminal value	511,720
Enterprise value	840,702
Add Investments	83
Net debt	(49,245)
Net present value-equity	890,030
Shares o/s	490
Target price /share(Rs)	1,818

Terminal multiples	
EV/EBIDTA	10.4
P/FCF	17.0

Terminal value calculation	
Cash flow in terminal year	80,613
Growth to perpetuity (g)	6.0%
Capitalisation rate (WACC-g)	6.3%
Terminal value	1,289,801
Discount period (years)	8.0
Discount factor	0.40
Discounted terminal value	511,720

WACC calculation	
Risk-free rate (Rf)	6.0%
Beta (B)	0.97
Equity risk premium	6.5%
Expected market Return (Rm)	12.5%
Cost of Equity (Ke)	12.3%
Cost of Debt (Kd) (Post-tax)	8.0%
WACC	12.3%

Note: We have used cash EBIT margins for DCF, effecting the margins in FY2010E, when we expect the employee cost related provisions to be realised as cash expense

Source: Kotak Institutional Equities estimates.

Exhibit 9: Bulk ordering is envisaged for following units of NTPC

Project/Location	Capacity (MW)	Configuration
Lara, Chhatisgarh	3,200	4X 800 MW
Darlipala, Orrisa	1,600	2X 800 MW
Barh extn, Bihar	1,600	2X 800 MW
North Karanpura	1,600	2X 800 MW
Total	8,000 MW	

Source: Infraline

Metals**TISC.BO, Rs544**

Rating	IL
Sector coverage view	Neutral
Target Price (Rs)	600
52W High -Low (Rs)	731 - 399
Market Cap (Rs bn)	468.0

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	175.5	188.6	195.8
Net Profit (Rs bn)	43.6	44.1	38.3
EPS (Rs)	50.7	51.3	44.6
EPS gth	(21.1)	1.1	(13.1)
P/E (x)	10.7	10.6	12.2
EV/EBITDA (x)	6.6	6.6	7.9
Div yield (%)	0.0	0.0	0.0

Shareholding, June 2007

	% of Pattern Portfolio	Over/(under) weight
Promoters	33.8	-
FIs	22.6	1.2
MFs	2.1	0.7
UTI	-	(1.2)
LIC	10.5	3.0

Tata Steel: Raise to In-Line; but, we won't turn buyers just yet

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- **Tata Steel stock has fallen 21% versus 9% fall in Sensex since our report on 26th July.**
- **We raise Tata Steel to In-Line as risk-reward now appears balanced. We won't turn buyers just yet; await lead-indicators to point to improving steel prices.**
- **Steel-prices in US sharply-down; EU stable in HR, but weakness otherwise.**
- **Regional steel stocks reaction starkly different; our analysis--Chinese exports to continue, sluggish US/EU quarter ahead.**
- **We look forward to consolidated-earnings announcement over the next month.**

Tata Steel's stock price has fallen 21% versus 9% fall in Sensex since our report dated 26th July. We raise Tata Steel to In-Line as risk-reward now appears to be balanced. We won't turn buyers as yet and are awaiting lead-indicators to point towards improving steel prices. Steel-prices in US are sharply-down while stable in EU. However, the weakness otherwise continues. We believe Chinese exports will continue and we shall see a sluggish US/EU quarter ahead. We look forward to Tata Steel-Corus consolidated-earnings announcement over the next month. We raise our target price to Rs600/share and revise our rating to In-Line (Under Perform previously).

Tata Steel reacts sharply to global cues

Tata Steel stock has fallen 21% versus 9% on benchmark Sensex after our re-initiation report on 26th July. Exhibit 1 gives Tata Steel's performance versus Sensex over that period.

Raise Tata Steel to In-Line...

After the correction, the stock trades below our initial target price of Rs640/ share (based on global steel stock valuation). However, global steel stocks have corrected in recent past too, which leads to a revision in target price of Tata Steel to Rs600/ share. We value Corus Group's EBITDA at 10% valuation discount to Tata Steel, citing lack of raw-material integration and resultantly high operating leverage. We value the investments of Tata Steel at Rs42/share in our SOTP-based valuation. Exhibit 2 gives our SOTP-based valuation for Tata Steel and Exhibit 3 gives global valuations.

...but, we will not turn buyers just yet, though

We await better pricing indication from lead-indicators be turn positive on Tata Steel again. We note that Tata Steel is among the most-leveraged (financial and operating) plays globally, and worse prices imply a greater hit on earnings versus peers. In a scenario of sober steel-prices, we believe investors are better-off invested in high-volume-growth, high long-product-focus and resource-rich companies like Jindal Steel & Power and JSW steel.

US lead-indicators not very positive

We note that recent US lead-indicators have not been positive. New housing starts have reduced 6% m-o-m and general residential expenditure has fallen 16.4% on YTD basis. Exhibit 4 gives details of new housing starts in US. In addition, the ISM-PMI (manufacturing) has reduced over m-o-m basis as well. Exhibit 5 gives trail of the index.

We note that Chinese steel-exports post introduction of export-duties has stayed strong contrary to most expectations. In our recent note 'CISA estimates might go for-a-toss' dated 14th August, we noted that China Iron and Steel Association's steel export estimates might turn out extremely-conservative. Exhibit 6 gives growth in Chinese steel production and exhibit 7 gives growth in Chinese steel exports. We also note that US imports of steel-products has fallen 36% on YTD basis, details of which are given in Exhibit 8.

Regional steel stocks stage a drama—our analysis points to stronger Chinese exports and weaker US/EU prices

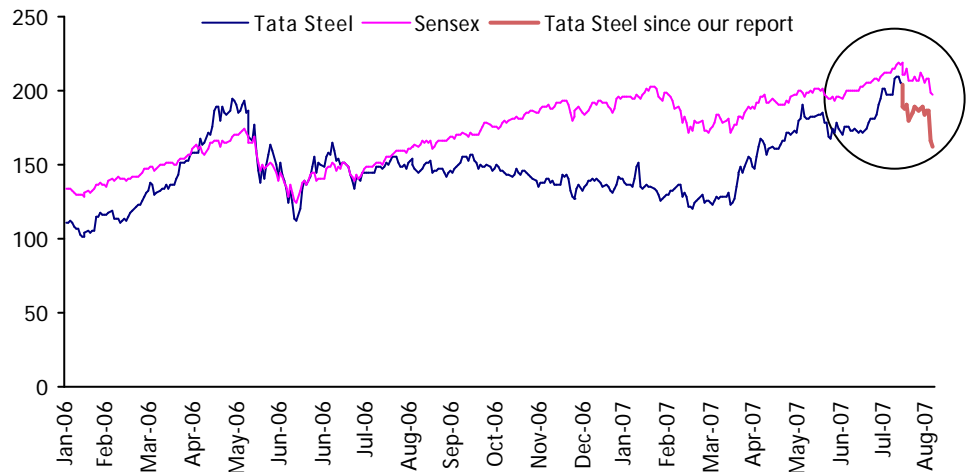
Regional steel-stocks' reaction has varied quite dramatically in response to the recent global-meltdown. Whereas stocks in US have drastically lost value and EU stocks sobered too, steel stocks in China have stayed firm and close to their all-time-highs. Recent pricing and trade-data too suggests that Chinese steel-exports might continue, albeit lower profitability and US prices will continue to stay soft (already fallen 17% from top) and EU might join US soon. Exhibit 9 gives steel-stock prices of various regional/global steelmakers.

We look forward to—announcement of consolidated earnings over the next month

Tata Steel is due to announce consolidated earnings over the next month. We expect strong growth from Corus Group, given the strong prices prevalent in the European region (where Corus draws approx. 60% of revenue).

Exhibit 1: Tata Steel has reacted negatively to global cues

Tata Steel relative to benchmark Sensex, March fiscal-year ends (%)



Source: Bloomberg, Kotak Institutional Equities

Exhibit 2: We reduce SOTP-based target price--in line with fall in global peers

SOTP-based target price of Tata Steel, March fiscal year-ends (Rs mn)

	EBITDA		Multiple (X)	Enterprise value		EV (Rs/share) (a)	Valuation basis
	(Rs mn)	(£ mn)		(Rs mn) (e)	(USD mn) (e)		
Tata Steel standalone	74,490	-	5.7	422,360	10,478	491	Based on 5% premium to FY2008E EV/EBITDA of global average 10% discount to Tata Steel EV/EBITDA Probability adjusted
Corus Group standalone (b)	91,561	1,107	5.1	467,235	11,591	543	
Present value of synergies				41,646	1,033	48	
Total Enterprise Value				931,242	23,102	1,083	
Tata Steel standalone net debt				41,580			FY2008E, adjusted for cash and marketable securities December 2007E, adjusted for cash and marketable securities
Corus Group standalone net debt				54,596			
Borrowings in Tata Steel Asia Holdings' account				44,341			
Borrowings in Tulpip UK's account				24,186			
Senior debt at Tata Steel UK's account (d)				161,240			
Mezzanine debt at Tata Steel UK's account (d)				124,961			
Total borrowings				450,905	11,186	524	
Arrived market capitalization				480,337	11,916	559	
Value of investments				36,114	896	42	
Market capitalization (including Investments)						601	
Target price (Rs)						600	Reduced from Rs640/ earlier

Notes:

(a) Based on fully diluted number of shares.

(b) Based on 2007 December-ended forecasted EBITDA.

(c) Currency conversion from GBP and USD into INR is based on current exchange rates.

(d) Refinanced by US\$6.2 bn by way of non-recourse debt, of which US\$3.3 bn is five year amortizing loan and balance is 7 year amortizing loan.

Source: Kotak Institutional Equities estimates

Exhibit 3: We peg Tata Steel's valuation to global peers

Key operating matrix and valuation of global companies, December fiscal year-ends (Rs mn)

Company name	Price (US\$)	Marketcap (US\$ mn)	Enterprise value (US\$ mn)	Valuation parameters								Ratios		
				EV/EBITDA (X)			Price-to-earnings (X)		Price-to-book (X)		Return on equity (%)		Dividend yield (%)	Debt-to-Equity (X)
				2007	2008E	2009E	2008E	2009E	2008E	2009E	2007	2008E		
Asia														
Nippon Steel	6.7	45,356	58,554	9.1	8.1	7.9	13.8	13.3	2.4	2.1	18.5	17.4	1.3	64.1
POSCO	479.2	41,782	42,717	5.7	5.3	4.9	8.9	8.8	1.2	1.1	16.5	15.8	2.0	19.8
Baoshan Iron & Steel	2.0	34,817	37,337	7.7	7.2	6.9	15.1	13.7	2.6	2.4	17.3	17.6	2.6	45.3
JFE Holdings	63.1	38,655	48,682	8.4	7.5	7.6	13.3	13.1	2.5	2.2	20.7	19.6	1.6	78.6
Angang Steel	3.5	19,767	21,832	10.0	7.9	6.0	15.2	12.9	4.3	3.2	24.3	24.8	2.2	59.4
Maanshan Iron & Steel	1.3	7,236	9,527	10.5	7.4	6.4	15.3	13.9	2.7	1.2	15.7	17.6	1.7	103.6
Hyundai Steel	57.1	4,845	6,919	7.0	6.6	5.7	8.7	8.6	1.0	0.9	13.1	12.2	-	65.0
SAIL	3.4	13,991	13,748	5.9	4.8	4.3	7.8	7.3	2.1	1.7	37.4	34.4	1.9	40.6
Asian average				8.0	6.8	6.2	12.3	11.4	2.3	1.8	20.4	19.9	1.9	59.5
Europe														
Acelor Mittal	53.0	75,220	104,842	5.8	5.3	5.5	7.3	7.2	1.2	1.1	19.7	19.1	2.6	63.1
Evrax Group	40.8	14,292	16,231	4.9	5.3	5.3	0.1	9.0	2.3	1.8	41.1	34.3	3.8	65.0
Thyssenkrupp AG	52.3	26,907	28,759	3.9	4.0	3.9	9.1	9.2	1.7	1.4	21.3	18.5	2.9	44.5
Severstal	14.5	14,612		4.9	4.4	4.2	8.6	8.7	1.0	1.0	13.4	12.7	2.8	27.2
European average				4.8	4.7	4.7	6.2	8.5	1.6	1.3	23.9	21.2	3.0	49.9
America														
CSN	45.2	12,286	15,294	5.9	5.2	5.8	9.6	10.7	2.9	2.8	32.9	28.7	6.4	153.9
Nucor Corp	45.9	13,734	13,940	4.6	4.4	4.5	8.3	9.2	2.1	2.0	30.3	28.1	4.2	19.1
US Steel	80.4	9,507	10,741	5.3	5.0	5.0	8.1	8.4	1.5	1.4	24.9	20.0	1.1	25.0
American average				5.2	4.9	5.1	8.7	9.4	2.2	2.0	29.3	25.6	3.9	66.0
Global average				6.0	5.5	5.3	9.1	9.8	2.0	1.7	24.5	22.2	2.9	58.5

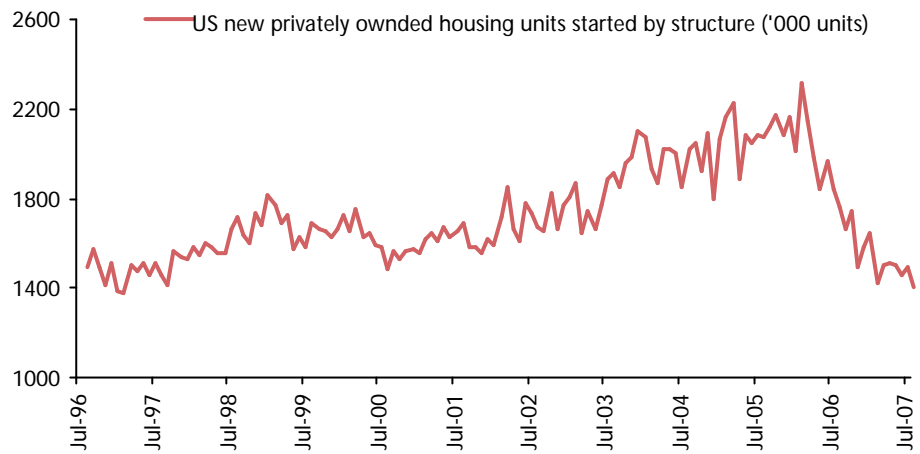
Notes:

(a) All numbers are calendarized year-end

Source: Bloomberg estimates; compiled by Kotak Institutional Equities

Exhibit 4: New housing starts reduce to lowest-point in decade

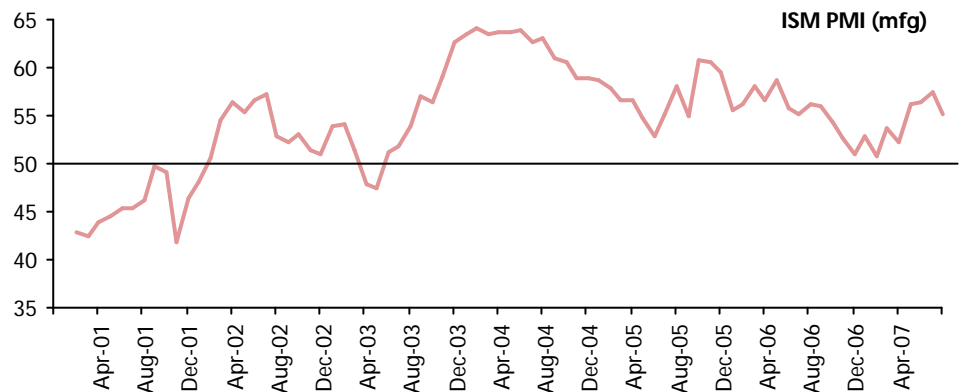
US new privately owned housing units started by structure



Source: US Dept of Commerce, compiled by Kotak Institutional Equities

Exhibit 5: ISM PMI (mfg) reduces in July-07; still in positive trajectory though

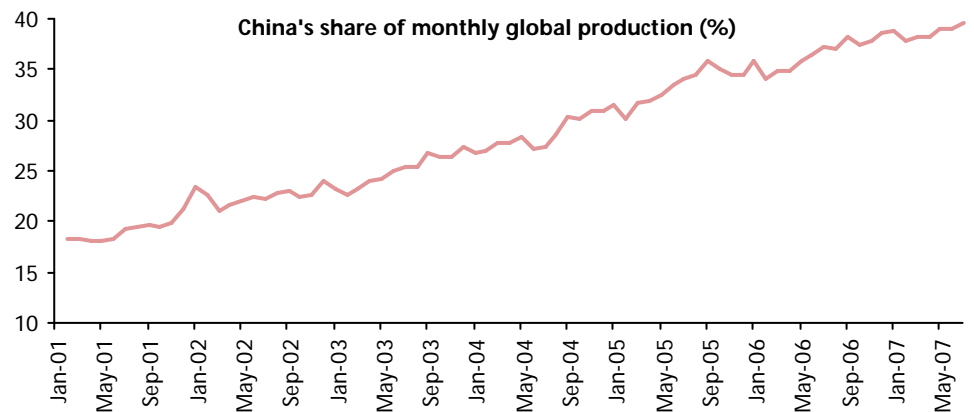
ISM PMI (mfg), index



Source: Econstats.com; compiled by Kotak Institutional Equities

Exhibit 6: Despite all the measures by the State, China's steel production has keeps on increasing

China's share of monthly productino, 2001-07 (%)



Source: IISI, compiled by Kotak Institutional Equities estimates

Exhibit 7: Export taxes has not been able to reduce Chinese exports

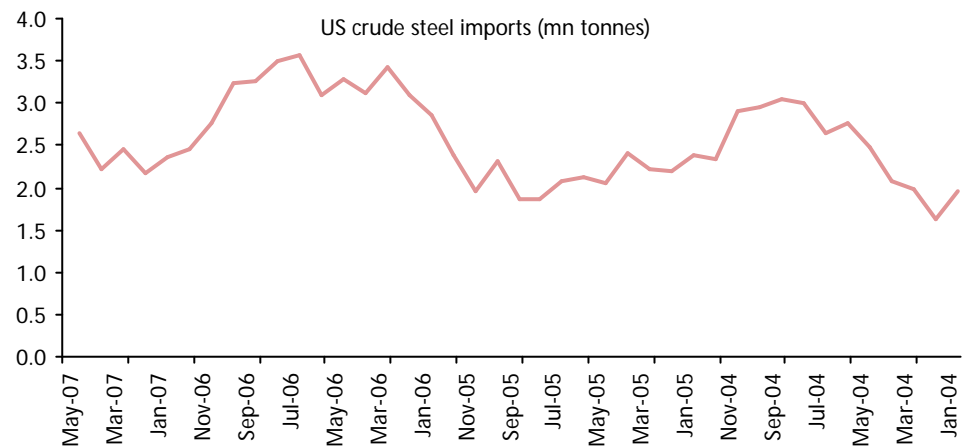
Chinese net exports, ('000tonnes)



Source: CISA, Steelhome, Kotak Institutional Equities

Exhibit 8: US crude steel imports have moderated in 2007

US crude steel imports, Jan 2004 to recently published data

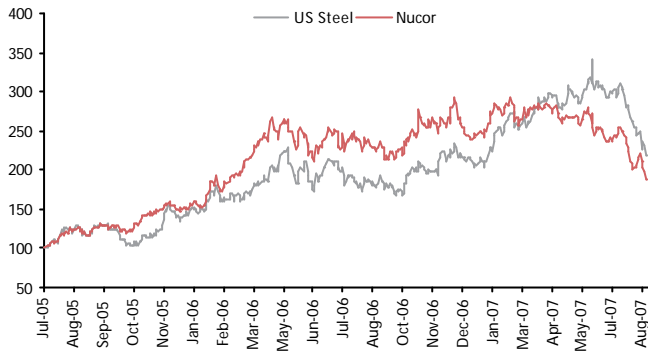


Source: US Census Bureau, Kotak Institutional Equities

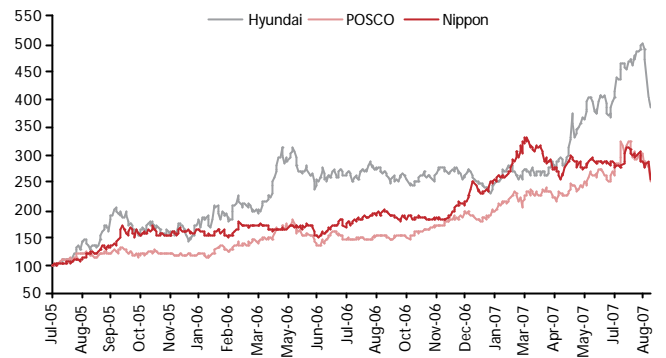
Exhibit 9: Regional steel-stocks have reacted sharply

Regional steel stock performance (%)

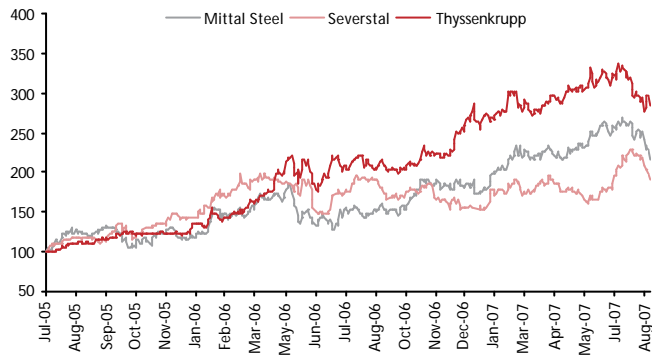
US



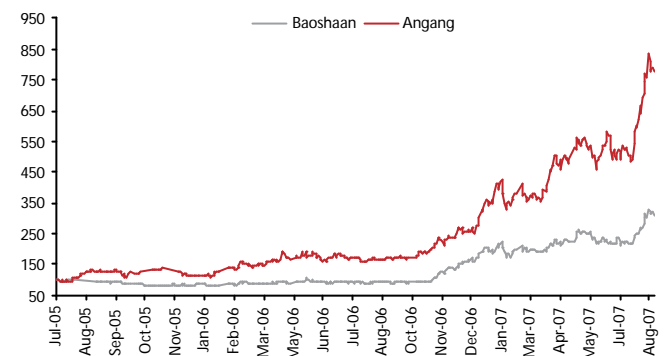
ASIA



Europe



China



Source: Bloomberg, Kotak Institutional Equities

Tata Steel, Profit model, March fiscal year-ends, 2005-2010E (Rs mn)

	2005	2006	2007	2008E	2009E	2010E
Net sales	144,990	151,394	175,520	188,642	195,847	212,844
Incl/(dec) in stock	(2,896)	(1,049)	(825)	(828)	(454)	(1,072)
Raw materials	17,151	23,683	31,215	33,544	37,708	43,642
Employee costs	12,925	13,515	14,548	15,748	17,025	18,391
Other manufacturing costs	25,215	28,756	32,918	35,858	42,100	50,743
Purchase for sale	13,053	6,561	4,506	4,416	4,328	4,241
SG&A	19,087	20,613	23,425	25,413	28,674	33,202
EBITDA	60,454	59,315	69,732	74,490	66,467	63,698
Non Operational Other income	1,900	3,048	4,337	2,146	2,146	2,146
EBITDA (incl other income)	62,354	62,363	74,069	76,636	68,613	65,844
Interest	2,288	1,684	1,739	1,854	1,124	3,786
Depreciation	6,188	7,751	8,193	8,472	9,915	11,383
Extra-ordinary items	(905)	(528)	(1,521)	(1,369)	(1,369)	(1,369)
Profit before tax	52,973	52,400	62,616	64,940	56,205	49,306
Tax	18,231	17,336	20,395	22,073	19,104	16,759
Profit after tax	34,742	35,064	42,221	42,867	37,101	32,547
Yearend shares outstanding (mn)	554	554	581	773	773	860
Weighted Average shares (mn)	554	554	567	677	773	817
Fully diluted shares outstanding (mn)	554	554	860	860	860	860
EPS (Rs) (using wtd avg shares)	62.7	63.3	74.4	63.3	48.0	39.9
Diluted EPS (Rs)	62.7	63.3	49.1	49.9	43.1	37.9
Margins (%)						
Gross margins	90.2	85.0	82.7	82.7	81.0	80.0
EBITDA margins	41.7	39.2	39.7	39.5	33.9	29.9
PBT margins	36.5	34.6	35.7	34.4	28.7	23.2
Net profit margins	24.0	23.2	24.1	22.7	18.9	15.3
Effective tax rate	34.4	33.1	32.6	34.0	34.0	34.0
Growth (%)						
Revenue	35.5	4.4	15.9	7.5	3.8	8.7
EBITDA	73.0	(1.9)	17.6	6.8	(10.8)	(4.2)
PBT	98.7	(1.1)	19.5	3.7	(13.5)	(12.3)
Net profit	99.0	0.9	20.4	1.5	(13.5)	(12.3)
Diluted EPS	99.0	0.9	(22.5)	1.5	(13.5)	(12.3)

Source: Company, Kotak Institutional Equities

Tata Steel, Balance sheet model, March fiscal year-ends, 2005-2010E (Rs mn)

	2005	2006	2007	2008E	2009E	2010E
Sources of Funds						
Share capital	5,537	5,537	5,807	7,730	7,730	8,600
Reserves and surplus	65,063	92,016	135,155	278,636	303,961	322,556
Deferred tax liability	8,294	9,570	7,489	8,788	9,912	10,898
Total equity	78,893	107,123	148,451	295,154	321,603	342,055
Secured loans	24,682	21,917	37,589	37,589	67,152	133,749
Unsecured loans	2,715	3,244	58,864	6,045	6,045	6,045
Total borrowings	27,397	25,162	96,453	43,634	73,197	139,794
Current liabilities	37,000	38,087	54,537	59,192	60,922	65,718
Other liabilities	15,143	13,887	11,071	12,440	13,809	15,178
Total Sources of Funds	158,433	184,259	310,512	410,421	469,530	562,744
Uses of Funds						
Cash	2,467	2,884	76,814	2,054	2,259	2,485
Other Current assets	38,369	39,492	60,205	62,422	63,639	66,510
Gross block	130,851	153,130	159,291	163,791	214,291	219,791
Less: accumulated depreciation	58,455	66,057	73,860	82,332	92,247	103,630
Net fixed assets	72,396	87,073	85,431	81,459	122,044	116,161
Capital work-in-progress	18,727	11,577	24,974	59,974	77,076	173,076
Total fixed assets	91,122	98,651	110,406	141,433	199,120	289,237
Investments	24,327	40,700	61,062	202,487	202,487	202,487
Misc expenditure	2,148	2,533	2,025	2,025	2,025	2,025
Total Uses of Funds	158,433	184,259	310,512	410,421	469,530	562,744

Source: Company, Kotak Institutional Equities

Tata Steel, Cash flow model, March fiscal year-ends, 2005-2010E (Rs mn)

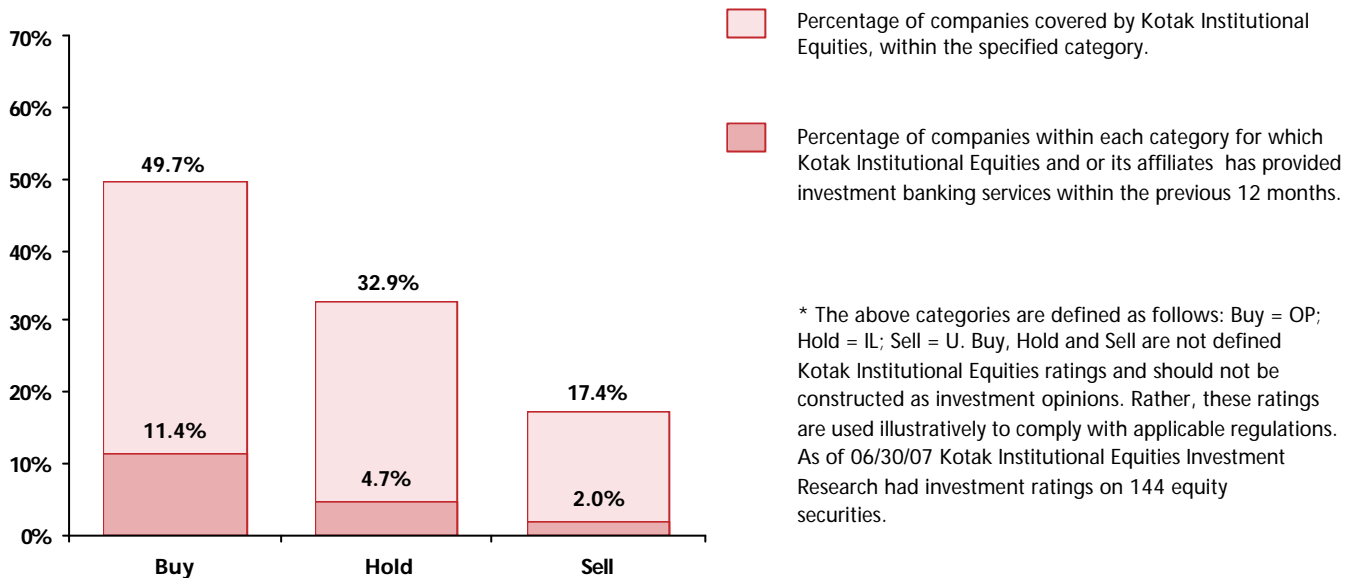
	2005	2006	2007	2008E	2009E	2010E
Cash flow from operating activities						
PBT	52,973	52,400	62,616	64,940	56,205	49,306
Add: Depreciation	6,188	7,751	8,193	8,472	9,915	11,383
Add: Non cash expenses	(928)		(2,601)			
Less: Expenses capitalised						
Less: Taxes paid	(18,182)	(16,375)	(20,346)	(20,774)	(17,980)	(15,773)
Add: Working capital changes	(1,907)	279	3,319	101	513	622
Total operating cash flow	38,144	44,054	51,181	52,739	48,653	45,538
Cash flow from investing activities						
Capital expenditure	(19,382)	(15,279)	(19,898)	(39,500)	(67,602)	(101,500)
Investments	(7,894)	(16,373)	(38,208)	—	—	—
Misc expenditure not written off	1,235	(385)	3,831	—	—	—
Total investing cash flow	(26,041)	(32,037)	(54,276)	(39,500)	(67,602)	(101,500)
Cash flow from financing activities						
Share issuances	—	—	15,403	114,315	—	—
Loans	(6,388)	(2,236)	71,077	(52,819)	29,563	66,596
Investments	—	—	—	36,925		
Less: Dividends paid (including dividend tax)	(3,678)	(8,204)	(7,177)	(9,439)	(11,777)	(11,777)
Other long term liabilities	(2,077)	(1,161)	(2,279)	(176,981)	1,369	1,369
Total financing cash flow	(12,142)	(11,601)	77,025	(87,998)	19,155	56,188
Net change in cash	(40)	417	73,929	(74,759)	205	226
Opening cash	2,507	2,467	2,884	76,813	2,054	2,259
Closing cash	2,467	2,884	76,813	2,054	2,259	2,485

Source: Company, Kotak Institutional Equities

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Distribution of ratings/investment banking relationships



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As of June 30, 2007

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IL = In-Line. We expect this stock to perform in line with the BSE Sensex over the next 12 months.

U = Underperform. We expect this stock to underperform the BSE Sensex over the next 12 months.

Our target price are also on 12-month horizon basis.

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