

June 30, 2008

Rating	Market Performer
Price	Rs600
Target Price	Rs730
Implied Upside	21.7%
Sensex	13,462

(Prices as on June 30, 2008)

Trading Data

Market Cap. (Rs bn)	17.0
Shares o/s (m)	28.4
Free Float	29.6%
3M Avg. Daily Vol ('000)	29.3
3M Avg. Daily Value (Rs m)	21.3

Major Shareholders

Promoters	70.4%
Foreign	5.7%
Domestic Inst.	3.8%
Public & Others	20.1%

Stock Performance

(%)	1M	6M	12M
Absolute	(19.6)	(67.5)	NA
Relative	(1.6)	(33.9)	NA

Annual Report 2008



Motilal Oswal Financial Services

FY08 annual report analysis

- **First annual report since listing:** In its first annual report since listing, Motilal Oswal Financial Services' (MOFSL) management explains its core business model, it's rapidly scaled up infrastructure and expanded management bandwidth.
- **Strong growth, but greater diversification needed:** FY08 has been a record year for the company, and it has used the opportunity to significantly strengthen its broking franchise, gather momentum in investment banking and enter new areas such as asset management. However, with 81.5% of its revenue from just broking, MOFSL remains less diversified than some of its peers.
- **Rapid growth in capital base; RoE declining:** The company's capital employed has grown 7.5 times from FY06 to FY08. While this has significantly strengthened its ability to grow its various businesses, its return ratios have kept deteriorating. From 55.0% in FY06, the RoE has dropped to 30.0% in FY08 and will further decline to 18.2% in FY09E.
- **Cost structure more flexible than generally believed:** Our analysis of the company's operating cost structure reveals that nearly 60% of its costs are variable in nature. Thus the widely held belief of a rout in earnings of broking companies in general and MOFSL in particular may be misplaced.
- **Valuation attractive for the long-term:** At 2.0x FY09E and 1.7x FY10E book value, MOFSL is clearly a value pick for the long-term investor. But despite the management's best efforts, FY09 is likely to be a tough year for the company given the market environment. We maintain Market Performer rating on the stock for now, but would be definite buyers in a more stable market environment.

Key financials (Y/e March)	FY07	FY08	FY09E	FY10E
Revenue (Rs m)	3,687	6,898	6,811	8,695
<i>Growth (%)</i>	<i>42.3</i>	<i>87.1</i>	<i>(1.3)</i>	<i>27.7</i>
EBITDA (Rs m)	1,379	2,584	2,438	3,207
PAT (Rs m)	787	1,610	1,469	1,846
EPS (Rs)	29.9	55.0	49.4	60.8
<i>Growth (%)</i>	<i>145.0</i>	<i>83.9</i>	<i>(10.2)</i>	<i>23.2</i>
Net DPS (Rs)	-	9.3	5.0	7.0

Source: Company Data; PL Research

Profitability & valuation	FY07	FY08	FY09E	FY10E
<i>EBITDA margin (%)</i>	<i>37.4</i>	<i>37.5</i>	<i>35.8</i>	<i>36.9</i>
<i>RoE (%)</i>	<i>35.8</i>	<i>30.0</i>	<i>18.2</i>	<i>19.0</i>
<i>RoCE (%)</i>	<i>36.2</i>	<i>27.6</i>	<i>16.0</i>	<i>15.5</i>
EV / sales (x)	3.9	2.1	2.5	2.0
EV / EBITDA (x)	10.3	5.6	7.1	5.3
PE (x)	20.1	10.9	12.2	9.9
P / BV (x)	4.6	2.4	2.0	1.7
<i>Net dividend yield (%)</i>	<i>-</i>	<i>1.6</i>	<i>0.8</i>	<i>1.2</i>

Source: Company Data; PL Research

Apurva Shah
 ApurvaShah@PLIndia.com
 +91-22-6632 2214

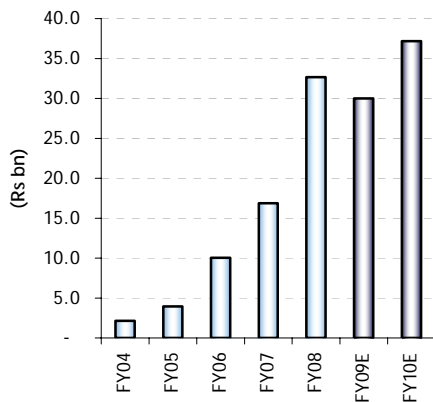


Strong overall performance

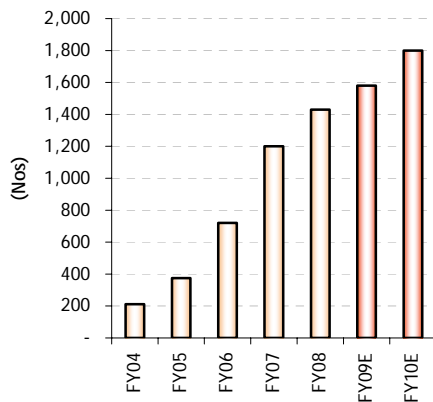
The best year in recent times

MOFSL's revenue and profits grew by a solid 87.1% and 105.5% respectively in FY08. Supported by favourable equity market tailwinds, the company strengthened its core broking business, gathered momentum in investment banking and explored new segments such as asset management. The company also significantly scaled up its infrastructure, management bandwidth and organisational capabilities.

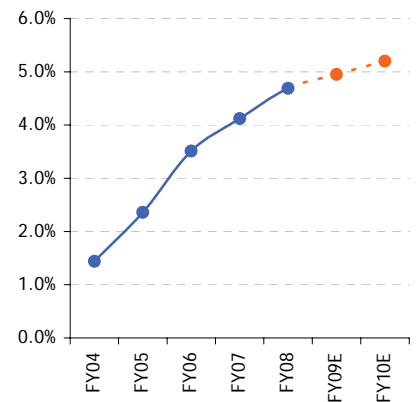
Average daily volumes



Retail outlets



Equity broking market share

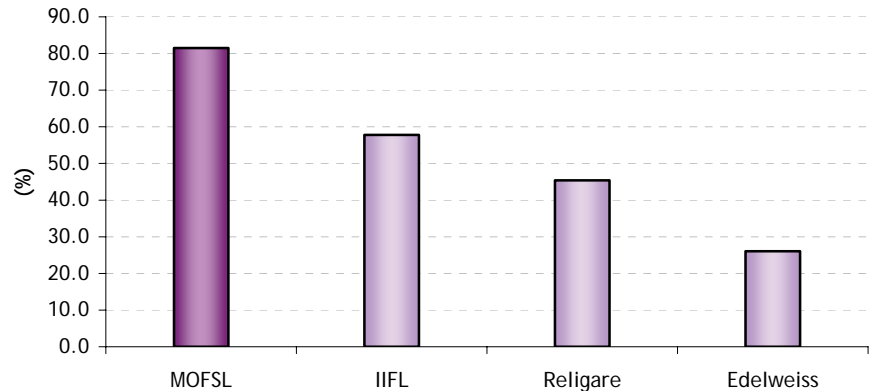


Source: Company Data, PL Research

Broking is 81.5% of revenue, will reduce going forward

Of the various financial services/capital market companies we cover, MOFSL gets the highest proportion of its revenue from broking activities. In FY08, MOFSL got 81.5% of its revenue from broking compared to 86.5% in FY07. While this lower degree of diversification increases the risk profile of the company, we expect the diversification to increase materially over the next couple of years. We forecast MOFSL to get 73.2% and 68.0% of its revenue from broking in FY09E and FY10E respectively.

Proportion of broking revenue to total (FY08)



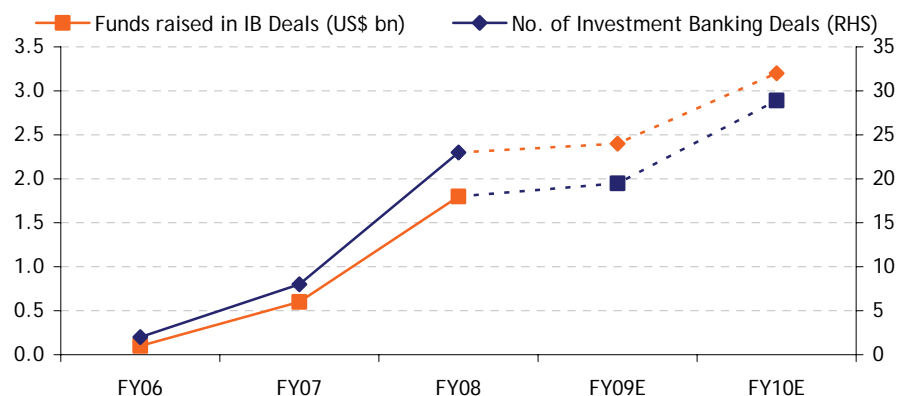
Source: Company Data, PL Research

IB and asset management expected to be growth drivers

MOFSL is a relatively minor player in investment banking in India. However, it is building its profile and team with larger ambitions in this competitive but lucrative business. In FY08, the company completed 23 transactions and helped raise US\$1.8bn for its clients. The company has a good team and a low base in its favour, but a weak market and formidable competitors going against it. We have estimated MOFSL's revenue from IB at Rs952m and Rs1,517m in FY09E and FY10E respectively compared to Rs628m in FY08.

Asset management revenue comprise of fees from its PMS book and offshore funds. Going forward it will also include income from onshore mutual fund business. We have modelled a decline of 8.9% in asset management revenue in FY09E due to reduced profit sharing in the PMS book. However, in FY10 we expect the size of the offshore asset to grow and also onshore mutual fund business to contribute materially. We estimate revenue from this segment to decline by 8.9% in FY09E and grow 73.6% in FY10E.

Investment banking performance

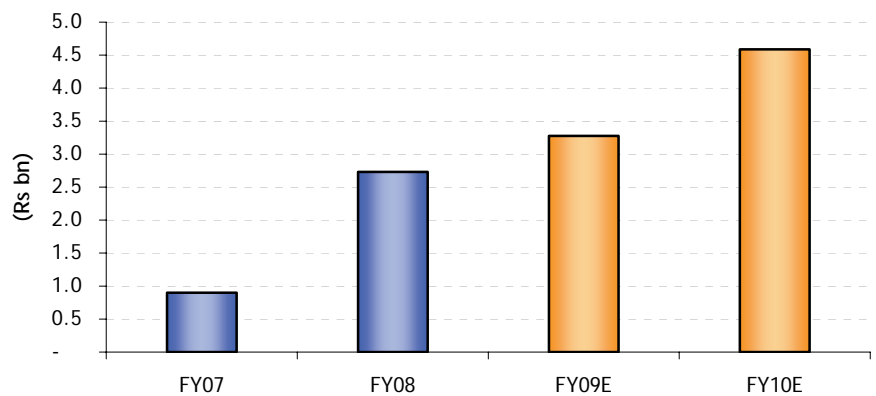


Source: Company Data, PL Research

Ambitions in financing business are limited compared to peers

MOFSL's peers such as India Infoline, Edelweiss, IndiaBulls, etc. have big plans to grow their lending businesses. For example, India Infoline will expand into consumer finance (expected book size in FY09E to be Rs16.8bn) business and Edelweiss will grow its wholesale financing book substantially (expected book size of Rs25.0bn by FY09E). MOFSL, on the other hand, has advances book of Rs2.73bn as of March 2008, largely comprising of margin funding, loan-against-share, IPO funding, etc. The company has no major ambitions in this area and intends to use the funding book only as a support to its core agency businesses rather than develop it as an independent business segment.

Margin funding book



Source: Company Data, PL Research

Rapid growth in balance sheet size

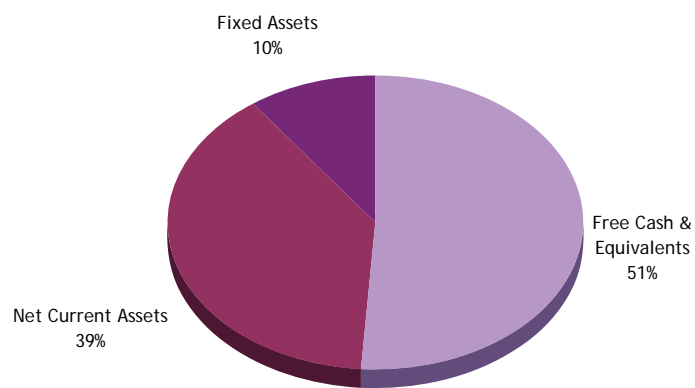
Receivables under control, no signs of any stress

MOFSL's receivables grew by just 13.1% in FY08 to Rs3,175m against 81.1% growth in broking and IB revenue. Despite extreme market volatility in Q4FY08, MOFSL had written-off just Rs16.4m for the year. The numbers clearly show no signs of stress on account of receivables. But it must be pointed out that given the nature of the business (receivables form a huge portion of revenue due to pay-in obligations of trades done on March 31, 2008), it is quite impossible to tell independently if there are any bad debts not yet written-off. However, our interactions with the management lead us to believe that there is no problem on this count being faced by the firm. Loans & advances have grown 96.6% to Rs4,737m. This was mainly driven by growth in its funding book to Rs2,730m in FY08 from Rs900m in FY07.

44% of cash & equivalents under lien as margins

MOFSL has Rs7,922m as cash & equivalents forming a stupendous 91.7% of its total balance sheet. However, of this about Rs3,488m are under lien with banks for providing bank guarantees for its exchange deposits/margins. Thus the free cash-on-hand is about Rs4,418m (51% of balance sheet). Clearly, MOFSL is in a very comfortable liquidity situation, especially given that its leverage remains low. But this excessive liquidity has taken a heavy toll on the company's return ratios.

Consolidated balance sheet break-up (FY08)



Source: Company Data, PL Research

RoE continues to decline

MOFSL's RoCE has been declining from FY06 onwards and we expect the same to continue in FY09E and FY10E as well. From 55.1% in FY06 we expect it to decline to 16.0% in FY09E and 15.5% in FY10E. The decline is mainly due to continuously reducing asset turnover as a result of the rapidly growing capital base. The company's capital employed has grown from Rs1,145m in FY06 to Rs8,638m in FY08 (CAGR of 175%). The entire decline in RoCE is not transmitted to RoE due to some increase in leverage. Nevertheless, overall the gearing of the company remains low with net cash in FY08.

RoE decomposition

	FY06	FY07	FY08	FY09E	FY10E
EBIT Margin	34.6%	34.8%	36.3%	33.9%	35.1%
Asset Turnover	238.0%	164.0%	116.7%	72.5%	70.3%
Tax Impact	67.0%	63.4%	65.1%	64.9%	62.7%
RoCE	55.1%	36.2%	27.6%	16.0%	15.5%
Leverage Impact	103.3%	101.9%	115.3%	124.1%	138.2%
Interest Impact	96.6%	96.9%	94.2%	91.9%	89.0%
RoE	55.0%	35.8%	30.0%	18.2%	19.0%

Source: Company Data, PL Research

Cost structure is more flexible than is generally believed

The management of MOFSL has guided that its cost structure is marginally over 50% variable. In order to test this claim, we did some analysis of the cost structure. It is obviously debatable as to what exactly constitutes fixed and variable costs. Besides, certain cost elements have both a fixed as well as a variable component. We have used assumptions in our analysis that we think provide the best estimate. So we have assumed entire employee expenses plus 25% of bonuses as 'fixed' and 60% of director's (i.e. senior management) remuneration as 'fixed'. On the other hand, we have assumed brokerage sharing with intermediaries as fully 'variable' and marketing & advertisement expenses too as fully 'variable'.

Cost structure analysis

(Rs m)

	FY07	FY08
Variable expenses		
Employee costs (75% of ex-gratia)	283	535
Directors commission	42	76
Brokerage sharing with franchisees	811	1,733
Marketing / advt. costs	68	160
Total variable costs	1,205	2,504
<i>% of total expenses</i>	<i>52.2</i>	<i>58.1</i>
Fixed expenses		
Employees (basic salaries + 25% ex-gratia)	624	1,039
Directors salaries	63	114
Other operating costs	26	36
Administrative expenses	391	620
Total fixed costs	1,104	1,809
<i>% of total expenses</i>	<i>47.8</i>	<i>41.9</i>
Total operating expenses	2,308	4,313

Source: MOFSL FY08 Annual Report, PL Research

From the table above, it appears the management guidance about its cost structure may have been conservative. Against guidance of about 50%, our analysis indicates that nearly 60% of operating cost is variable. It was indeed about 50% variable in FY07, but higher marketing/advertisement expenses and greater portion of sharing with intermediaries has tilted the cost structure towards being more variable and hence more flexible. Thus, the widely held belief of a complete rout of profitability of broking firms in general and MOFSL in particular are perhaps quite misplaced.



Financials

Income Statement

(Rs m)

Y/e March	FY06	FY07	FY08	FY09E	FY10E
Fund-based income	-	147	365	616	786
<i>% of total income</i>		<i>4.0</i>	<i>5.3</i>	<i>9.0</i>	<i>9.0</i>
Brokerage income	2,441	3,191	5,621	4,985	5,942
<i>% of total income</i>	<i>94.2</i>	<i>86.5</i>	<i>81.5</i>	<i>73.2</i>	<i>68.3</i>
Asset mgmt fees	150	90	284	259	449
<i>% of total income</i>	<i>5.8</i>	<i>2.4</i>	<i>4.1</i>	<i>3.8</i>	<i>5.2</i>
Investment banking	-	259	628	952	1,517
<i>% of total income</i>		<i>7.0</i>	<i>9.1</i>	<i>14.0</i>	<i>17.5</i>
Total income	2,591	3,687	6,898	6,811	8,695
<i>YoY gr. (%)</i>		<i>42.3</i>	<i>87.1</i>	<i>(1.3)</i>	<i>27.7</i>
Expenses					
Employee expenses	631	1,012	1,764	1,785	2,228
<i>% of total income</i>	<i>24.4</i>	<i>27.4</i>	<i>25.6</i>	<i>26.2</i>	<i>25.6</i>
Admin expenses	308	460	780	940	1,174
<i>% of total income</i>	<i>11.9</i>	<i>12.5</i>	<i>10.6</i>	<i>13.8</i>	<i>13.5</i>
Operating expenses	788	837	1,769	1,648	2,087
<i>% of total income</i>	<i>30.4</i>	<i>22.7</i>	<i>25.8</i>	<i>24.2</i>	<i>24.0</i>
Total operating expenses	1,728	2,308	4,313	4,373	5,488
EBIDTA	863	1,379	2,584	2,438	3,207
<i>EBIDTA margin (%)</i>	<i>33.3</i>	<i>37.4</i>	<i>37.5</i>	<i>35.8</i>	<i>36.9</i>
Depreciation	55	110	149	210	240
Interest expenses	32	39	149	190	341
Other income	135	22	111	123	130
PBT	910	1,251	2,398	2,161	2,756
Exceptional item (exp. twd ESOP)	-	54	-	-	-
Adjusted PBT	910	1,197	2,398	2,161	2,756
<i>% of the revenue</i>	<i>35.1</i>	<i>32.5</i>	<i>34.8</i>	<i>31.7</i>	<i>31.7</i>
Tax	300	410	788	691	909
<i>ETR (%)</i>	<i>32.9</i>	<i>34.3</i>	<i>33.5</i>	<i>32.0</i>	<i>33.0</i>
PAT	610	787	1,610	1,469	1,846
Minority interest	0.5	27	50	67	118
PAT after minority interest	610	760	1561	1402	1728
Extraordinary item	-	42	(147)	-	-
Adjusted PAT	610	718	1,708	1,402	1,728
No. of shares O/S	50.0	25.4	28.4	28.4	28.4
EPS	12.2	29.9	55.0	49.4	60.8
<i>YoY gr. (%)</i>	-	<i>145.0</i>	<i>83.9</i>	<i>(10.2)</i>	<i>23.2</i>



Balance Sheet

(Rs m)

Y/e March	FY06	FY07	FY08	FY09E	FY10E
Sources of funds					
Equity	56	127	142	142	142
Reserves & surplus	1,052	3,205	6,948	8,187	9,686
Networth	1,108	3,332	7,090	8,329	9,828
Secured loan funds	22	0	1,455	2,000	4,500
Minority interest	0	30	80	147	265
Deff. tax liability	14	15	13	15	15
Total liabilities	1,145	3,377	8,638	10,490	14,607
Application of funds					
Gross fixed assets	670	966	1,276	1,560	2,100
Depreciation	192	297	444	631	862
Net fixed assets	478	669	832	929	1,238
Capital WIP	40	16	22	42	55
Investments	79	856	3,639	4,548	5,458
Current assets	3,827	7,463	12,315	13,809	15,873
Sundry debtors	1,344	2,808	3,175	3,651	4,746
Stock in trade	18	-	17	13	22
Cash & bank	1,238	2,165	4,267	4,594	4,178
Loans & advances	1,214	2,410	4,737	5,276	6,587
Other assets	12	81	119	275	340
Current liabilities	2,611	4,498	5,574	6,243	6,867
Provisions	668	1,130	2,596	2,596	1,149
Net current assets	547	1,836	4,145	4,971	7,856
Total	1,145	3,377	8,638	10,490	14,607



Prabhudas Lilladher Pvt. Ltd.

3rd Floor, Sadhana House, 570, P. B. Marg, Worli, Mumbai-400 018, India.

Tel: (91 22) 6632 2222 Fax: (91 22) 6632 2209

PL's Recommendation Nomenclature

BUY	: > 15% Outperformance to BSE Sensex	Outperformer (OP)	: 5 to 15% Outperformance to Sensex
Market Performer (MP)	: -5 to 5% of Sensex Movement	Underperformer (UP)	: -5 to -15% of Underperformance to Sensex
Sell	: <-15% Relative to Sensex		
Not Rated (NR)	: No specific call on the stock	Under Review (UR)	: Rating likely to change shortly

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