kotak® Institutional Equities

INDIA DAILY

November 20, 2007

EQUITY MARKETS

India	19-Nov	1-day	1-mo	3-mo
		Change, %		
Sensex	19,633	(0.3)	11.8	36.1
Nifty	5,908	0.0	13.3	40.4
Global/Regional indices				
Dow Jones	12,958	(1.7)	(4.2)	(1.2)
Nasdaq Composite	2,593	(1.7)	(4.8)	3.4
FTSE	6,121	(2.7)	(6.2)	0.7
Nikkie	14,757	(1.9)	(12.2)	(6.2)
Hang Seng	26,520	(3.4)	(10.0)	22.8
KOSPI	1,821	(3.8)	(7.6)	5.2

Value traded - India

	19-Nov		1-mo	3-mo
			Moving avg, Rs bn	
Cash (NSE+BSE)	263.7		292.9	240.3
Derivatives (NSE)	518.4		831.0	648.8
Deri. open interest	1,063.2		956.9	870.2

Forex/money market

	19-Nov	1-day	1-mo	3-mo
		Change, basis points		
Rs/US$	39.3	-	(56)	(163)
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	7.9	(1)	1	(8)

Net investment (US$mn)

	16-Nov		MTD	CYTD
FIIs	(20)		(129)	17,158
MFs	123		(19)	156

Top movers -3mo basis

Best performers	19-Nov	1-day	1-mo	3-mo
		Change, %		
Neyveli Lignite	215	(0.4)	85.9	180.4
Reliance Energy	1,827	0.1	37.1	151.9
Reliance Cap	2,398	4.9	60.1	128.3
Engineers India	911	(1.6)	67.7	98.2
Tata Tele	51	16.3	28.0	92.4
Worst performers				
i-Flex	1,453	2.7	(8.8)	(23.7)
Punjab Tractors	200	0.3	(7.6)	(17.5)
Infosys	1,620	(0.2)	(15.1)	(11.4)
Glaxosmithkline	1,041	0.9	0.6	(12.0)
Polaris	108	3.2	(4.5)	(6.6)

Contents

News Roundup

Corporate

- Banking consolidation in the public sector is set to deepen further with State Bank of India (SBI) seeking to expand its foothold beyond immediate associate banks by possibly absorbing Uco Bank and Dena Bank. (FE)
- Buoyed by the incredible growth of India's realty sector, the Trump organisation is scouting for a partner to enter the country within 18 months. (FE)
- Bottled water maker Bisleri International and Axis Bank have backed out of deals to sponsor Subash Chandra's Indian Cricket League ten days before it is scheduled to begin. (BS)
- Nicholas Piramal India Ltd and Merck & Co Inc have entered into an R&D collaboration agreement to discover and develop new drugs for two select targets provided by Merck. (FE)
- Ranbaxy Laboratories may dilute up to 60% stake in its new research company, which will be formed by hiving off its R&D unit into a separate entity in 2008. (ET)
- The exploration and production major ONGC is likely to declare a force majeure before the DGH for its inability to drill the required number of blocks due to the non-availability of rigs. (FE)

Economic and political

- The government is all set to allow 74% foreign direct investment (FDI) in cable TV services and Head-end in the Sky (HITS)--a satellite-based system to distribute television signal via cable--while also permitting 100% FDI is downlinking general and entertainment channels unlinked from abroad. (ET)

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

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Property

DLF.BO, Rs948	
Rating	ADD
Sector coverage view	Neutral
Target Price (Rs)	870
52W High -Low (Rs)	989 - 506
Market Cap (Rs bn)	1,616

Financials

April y/e	2007E	2008E	2009E
Sales (Rs bn)	39.2	137.0	178.1
Net Profit (Rs bn)	19.4	79.5	103.9
EPS (Rs)	12.7	46.6	61.0
EPS gth	*1.0*	*267.2*	*30.7*
P/E (x)	74.6	20.3	15.6
EV/EBITDA (x)	61.0	16.4	12.6
Div yield (%)	-	0.5	0.7

Shareholding, September 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	88.2	-	-
FIIs	7.3	1.1	(2.2)
MFs	0.3	0.3	(2.9)
UTI	-	-	(3.3)
LIC	-	-	(3.3)

DLF Limited: Private equity deal to accelerate cashflows

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- **DLF has sold a 49% stake in eight residential projects amounting to 69 mn sq. ft**
- **Retain target price of Rs870/share and ADD rating**

DLF has sold a 49% stake in eight of its residential projects to private equity investors for a total consideration of Rs16.8 bn. We believe the sale of stake in these projects amounting to 69 mn sq. ft will help accelerate cashflows for DLF. We adjust our financial estimates for this transaction and for the slight delay in residential projects in Gurgaon. As a result, our revenue estimates stand revised to Rs137 bn for FY2008 (Rs131 bn earlier) and Rs178 bn for FY2009 (Rs176 bn earlier). We revise our PAT estimates to Rs79.5 bn in FY2008 (Rs73 bn earlier) and Rs104 bn in FY2009 (Rs102 bn earlier). Our NAV for DLF stands revised to Rs717/share (Rs720/share earlier). Our target price of Rs870/share is based on 20% premium to NAV and we retain our ADD rating.

Description of the deal

DLF has entered into two separate transactions in order to raise Rs16.8 bn. DLF will raise Rs14.8 bn by sellinga 49% stake to Merrill Lynch in seven projects in four cities amounting to 63 mn sq. ft – Chennai (30 mn sq. ft), Bangalore (23 mn sq. ft), Kochi (3 mn sq. ft) and Indore (7 mn sq. ft). Similarly, DLF will raise Rs1.9 bn by selling a 49% stake to Brahma Investments in 6 mn sq. ft project at Panchkula, Chandigarh. Besides upfront consideration, DLF will be entitled to service fees for investment advisory and project management. Various components of the fees to be received by DLF are described below:

1) Project management fee. DLF will earn a project management fee of 7% of the project revenues.

2) Performance fee. Beyond a certain IRR, DLF is going to earn a disproportionate share of profits from these projects.

Private equity deal to help accelerate cashflows

We highlight that projects being sold to private equity investors are at an early stage of development and will be launched over the next 6-18 months. Since the saleable area in each of the eight projects is quite large, development will take place over the next 7-8 years. We believe DLF's strategy of selling stake will likely help it to monetize assets and reduce risks at a very early stage of development of these residential assets. This will help DLF focus on new opportunities as cash inflows accelerate from its existing project portfolio. We expect DLF to acquire more land parcels as it executes its strategy of establishing presence in all major Indian cities.

We retain our target price of Rs870/share; ADD rating

On the basis of the dilution of a 49% stake in DLF's residential projects, our NAV reduces by Rs3/share. Our revised NAV estimate for DLF is Rs717/share and our target price of Rs870 is based on a 20% premium to NAV. We assign a 20% premium on NAV on account of several factors (1) NAV accretion possibility on account of large ticket projects, (2) yield compression on its commercial assets—1% yield compression results in 4% enhancement to NAV, (3) progress of SEZs—potential NAV accretion is Rs100 bn or Rs58/share, (4) hotel business—we have only taken value of land, (5) power business—DLF has a 57.5 MW power plant and is entering wind power business, (6) value accretion from joint ventures—insurance, healthcare, telecom.

We estimate NAV of DLF at Rs717/share

	March '09 based NAV Growth rate in selling prices			
	0%	**3%**	**5%**	**10%**
Valuation of land reserves	**767.0**	**946.4**	**1,127.1**	**1,504.9**
Add: 22 Hotel sites	25	25	25	25
Add: Construction JV	20	20	20	20
Add: Other properties (plots in Gurgaon - 7.2 mn sq. ft, hotel site in Gurgaon)	22	22	22	22
Add: Present value of project management fees	8	8	8	8
Add: Investments as on March 31, 2008	20	20	20	20
Add: Bidadi township	65	65	65	65
Less: Net debt as on March 31, 2008	(23)	(23)	(23)	(23)
Less: Land cost to be paid as on March 31, 2008	(30)	(30)	(30)	(30)
NAV	**874**	**1,053**	**1,234**	**1,612**
Total no. of shares including ESOPs of 17 mn shares (mn)				1,722
NAV/share				**717**

Source: Kotak Institutional Equities

Profit model of DLF, March fiscal year-ends, 2005-2010E (Rs mn)

	2005	2006	2007	2008E	2009E	2010E
Total revenues	**6,082**	**11,536**	**39,233**	**137,018**	**178,061**	**214,999**
Land costs	(2,517)	(4,416)	(6,319)	(7,078)	(12,962)	(16,178)
Construction costs	—	—	—	(23,791)	(30,856)	(39,676)
Employee costs	(446)	(397)	(922)	(2,009)	(2,873)	(3,929)
SG&A costs	(1,435)	(1,966)	(3,958)	(4,187)	(5,284)	(6,261)
EBITDA	**1,684**	**4,757**	**28,034**	**99,953**	**126,086**	**148,955**
Other income	178	883	1,108	1,411	2,359	2,740
Interest	(390)	(1,685)	(3,076)	(3,109)	(593)	(1,470)
Depreciation	(333)	(361)	(571)	(1,303)	(1,641)	(3,378)
Pretax profits	**1,138**	**3,594**	**25,494**	**96,952**	**126,211**	**146,846**
Profit/(loss) share of associates	—	—	—	—	—	—
Current tax	(490)	(2,537)	(6,058)	(17,511)	(22,495)	(26,698)
Deferred tax	231	870	—	39	178	22
Net income	**879**	**1,927**	**19,436**	**79,480**	**103,893**	**120,170**
Reported net income	**865**	**1,917**	**19,425**	**79,480**	**103,893**	**120,170**
EPS (Rs)						
Primary	6.3	12.7	13.0	47.9	61	71
Fully diluted	6.3	12.7	13.0	47.4	60	70
Shares outstanding (mn)						
Year end	140	1,511	1,530	1,705	1,705	1,705
Primary	140	152	1,496	1,661	1,705	1,705
Fully diluted	140	152	1,496	1,678	1,722	1,722
Cash flow per share (Rs)						
Primary	5	18	4	45	60	72
Fully diluted	5	18	4	45	60	72
Growth (%)						
Net income (adjusted)	61	122	913	309	31	16
EPS (adjusted)	59	103	2	265	27	16
DCF/share	39	273	(77)	970	34	20
Cash tax rate (%)	43	71	24	18	18	18
Effective tax rate (%)	23	46	24	18	18	18

Source: Kotak Institutional Equities estimates.

Balance sheet of DLF, March fiscal year-ends, 2005-2010E (Rs mn)

	2005	2006	2007	2008E	2009E	2010E
Equity						
Share capital	35	378	3,059	3,409	3,409	3,409
Reserves/surplus	7,437	9,122	36,613	197,900	288,189	385,036
Total equity	**7,472**	**9,500**	**39,672**	**201,309**	**291,598**	**388,445**
Deferred tax liability/(asset)	963	93	187	148	(30)	(52)
Liabilities						
Secured loans	7,951	39,560	92,053	39,328	9,328	9,328
Unsecured loans	1,724	1,760	7,275	—	—	—
Total borrowings	**9,675**	**41,320**	**99,328**	**39,328**	**9,328**	**9,328**
Currrent liabilities	9,342	18,469	42,429	56,409	72,199	87,043
Total capital	**27,494**	**69,435**	**181,708**	**297,286**	**373,187**	**484,856**
Assets						
Cash	424	1,950	4,155	16,179	30,595	118,932
Current assets	15,939	35,113	124,639	204,868	223,640	209,747
Gross block	8,253	11,237	17,787	32,581	41,018	84,455
Less: accumulated depreciation	1,549	1,891	2,412	3,917	5,558	8,936
Net fixed assets	6,704	9,346	15,375	28,664	35,461	75,519
Capital work-in-progress	3,506	6,239	26,497	18,439	44,354	31,521
Total fixed assets	**10,210**	**15,585**	**41,872**	**47,102**	**79,814**	**107,040**
Intangible assets	—	—	—	—	—	—
Investments	921	16,789	11,042	28,935	38,935	48,935
Misc. expenses	—	—	—	202	202	202
Total assets	**27,494**	**69,437**	**181,708**	**297,286**	**373,187**	**484,856**
Leverage ratios (%)						
Debt/equity	114.7	430.7	249.2	19.5	3.2	2.4
Debt/capitalization	53.4	81.2	71.4	16.3	3.1	2.3
Net debt/equity	109.7	410.4	238.8	11.5	(7.3)	(28.2)
Net debt/capitalization	52.3	80.4	70.5	10.3	(7.9)	(39.3)
RoAE	**10.7**	**21.3**	**78.6**	**65.9**	**42.1**	**35.3**
RoACE	**5.3**	**4.5**	**22.9**	**43.2**	**38.5**	**34.7**

Source: Kotak Institutional Equities estimates.

Cash flow statement of DLF, March fiscal year-ends, 2005-2010E (Rs mn)

	2005	2006	2007	2008E	2009E	2010E
Operating						
Pre-tax profits before extraordinary items	1,138	3,595	25,495	96,952	126,211	146,846
Depreciation	334	362	571	1,303	1,641	3,378
Taxes paid	(448)	(751)	(6,078)	(17,511)	(22,495)	(26,698)
Other income	(1)	98	(13,857)	—	—	—
Interest expenses	315	970	3,076	3,109	593	1,470
Interest paid	(645)	(1,483)	(2,898)	(8,867)	(2,967)	(1,470)
Working capital changes (a)	4,415	(15,225)	(66,758)	(60,490)	(608)	28,737
Total operating	**5,108**	**(12,436)**	**(60,449)**	**14,496**	**102,374**	**152,263**
Operating, excl. working capital (b)	**693**	**2,789**	**6,309**	**74,985**	**102,982**	**123,526**
Investing						
Fixed assets	(8,299)	(3,863)	(18,878)	(6,736)	(34,353)	(30,603)
Investments	618	(14,797)	14,044	(17,893)	(10,000)	(10,000)
Total investing (c)	**(7,681)**	**(18,660)**	**(4,834)**	**(24,629)**	**(44,353)**	**(40,603)**
Financing						
Issue of share capital	—	—	—	91,875	—	—
Borrowings	2,734	32,638	58,007	(60,000)	(30,000)	—
Dividend (d)	(16)	(16)	(18)	(9,718)	(13,605)	(23,323)
Total financing	**2,718**	**32,622**	**67,487**	**22,157**	**(43,605)**	**(23,323)**
Net increase in cash and cash equivalents	146	1,526	2,204	12,024	14,416	88,337
Beginning cash	279	424	1,951	4,155	16,179	30,595
Ending cash	**424**	**1,951**	**4,155**	**16,179**	**30,595**	**118,932**
Gross cash flow (b)	693	2,789	6,309	74,985	102,982	123,526
Free cash flow (b) + (a) + (c)	**(2,572)**	**(31,096)**	**(65,283)**	**(10,133)**	**58,021**	**111,660**
Excess cash flow (b) +(a) + (c) + (d)	(2,588)	(31,112)	(65,301)	(19,851)	44,416	88,337

Source: Kotak Institutional Equities estimates.

Telecom

Sector coverage view			Cautious

		Price, Rs	
Company	**Rating**	**19-Nov**	**Target**
Bharti	REDUCE	907	775
Rcom	SELL	710	550
Idea Cellular	SELL	126	110

Telecom companies would be extremely profitable, even with RPM of just Rs0.5/minute

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- **Bharti would earn RoACE of 24%, even if RPM falls to Rs0.5/minute**
- **Competition and regulatory changes will likely erode current supernormal profitability**
- **Maintain REDUCE rating on Bharti and SELL ratings on Idea and RCOM**

We examine the impact of a potential decline in RPM on the profitability and returns of companies based on (1) recent regulatory developments, (2) DOT's internal note about outgoing tariffs declining by 50% with more competition and (3) likely introduction of MNP. We look at reasonable profitability, which companies may be able to earn in the long term in a capital-intensive and competitive market. We have computed earnings, EPM, RoAE and RoACE of Bharti at various RPM levels. Based on this sensitivity analysis, we believe that Bharti can earn RoACE of more than 20% even if RPM was to decline to Rs0.5/ minute from 2QFY08's Rs0.78/ minute. We believe current street estimates (including ours) are based on optimistic RPM and EPM assumptions of Rs0.7-0.8/min and Rs0.28-0.32/min throughout the forecast periods. However, these estimates could be at risk given increasing competition and regulatory risks (MNP, capex and more players in the market). We maintain our REDUCE rating on Bharti with a 12-month DCF-based target price of Rs775 and SELL ratings on Idea and RCOM with 12-month DCF-based target prices of Rs110 and Rs550, respectively.

Present level of profitability has a lot more scope to decline. Exhibit 1 gives the impact of lower RPM on EPM, EPS, RoAE, RoACE and our DCF valuation of Bharti; we use Bharti for illustration and believe the same exercise would hold good for RCOM and Idea also. In our analysis, we have assumed that the impact of MNP and higher competition would start impacting the industry from FY2010E. We conclude that even if the RPM was to decline by 35% to Rs0.5/min, Bharti would still earn a healthy RoACE of 20% in FY2010E (24% average for the next eight years), as compared to our present FY2010E RPM assumption of Rs0.69/ minute and RoACE of 31%. More important, our DCF-based fair value declines to Rs530 from the present Rs775. We note that we have not considered elasticity of demand in our calculations; the DCF-based fair valuation may be moderately higher in such an event. We highlight that consensus estimates are built on a benign pricing environment, which in our view is unlikely, especially after the recent regulatory developments.

Competition likely to increase. We believe competition is likely to intensify over the next 12-15 months on the back of the following potential developments.

1. **Potential roll out of GSM operations by RCOM.** RCOM has stated that it may pursue an aggressive price strategy to gain subscribers for its GSM platform. In any case, RCOM has been expanding coverage on its CDMA platform;
2. **Vodafone's aggressive market share aspirations.** It has reiterated its 25% market share aspirations from the current 17%. The company has stepped up its marketing spend, introduced attractive handset-bundling schemes and is banking on attractive customized tariff plans. Vodafone is currently adding more subs than RCOM and has closed the gap with Bharti on subs addition in the 16 common circles.

3. **Likely release of spectrum to new players and introduction of MNP.** Press reports indicate that the department may vacate 30-35 MHz in the next 2-6 months. In our view, this can accommodate the pan-Indian aspirations of Aircel, Idea, RCOM (GSM) and Vodafone and leave scope for the entry of new players in the market. Further, MNP will likely usher in true competition in the market, potentially impacting pricing and leading to higher subscriber acquisition cost; our analysis indicates that Bharti may stand to lose the most in such a scenario. Please refer to our note on MNP titled *'MNP—Consumers now have a choice, investors don't'* dated Nov 19, 2007

Our present fair value of Bharti is based on aggressive assumptions. Our 12-month fair value of Rs775 is based on fairly aggressive assumptions. We highlight that we model average RPM of Rs0.73/min for FY2008-17E (2QFY08 RPM = Rs0.78/min) and average EPM of Rs0.32/min for FY2008-17E (2QFY08 EPM = Rs0.32/min). Not surprisingly, our assumptions translate into average ROACE of 36.9% and average CROCI of 26.9% for FY2008-17E. However, incremental RPM and EPM for 2QFY08 for Bharti was just Rs0.5/min and Rs0.23/min, as shown in Exhibit 2.

Bharti would earn an average RoACE of 24%, even if the RPM was to fall to Rs0.5/min

Sensitivity analysis of EPS, EPM, RoAE and RoACE to RPM for Bharti, March fiscal year-ends, 2008E-17E

	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E
Current assumptions										
EPS (Rs)	34.6	45.7	55.5	64.4	64.9	70.9	75.0	80.2	82.4	90.6
RPM (Rs)	0.74	0.71	0.69	0.68	0.68	0.69	0.70	0.71	0.72	0.73
EPM (Rs)	0.32	0.31	0.31	0.31	0.31	0.31	0.32	0.32	0.33	0.33
RoACE (%)	32.1	31.4	30.9	32.0	31.1	34.3	37.6	42.2	45.6	52.1
RoAE (%)	43.2	38.7	33.9	32.7	31.3	34.7	38.3	43.4	47.3	54.7
12-month forward DCF value		**775**								
At RPM of 0.7										
EPS (Rs)	34.6	45.7	56.0	66.2	66.6	71.5	74.4	78.3	79.3	86.0
EPM (Rs)	0.32	0.31	0.31	0.31	0.32	0.32	0.32	0.32	0.32	0.32
RoACE (%)	32.1	31.4	31.2	33.0	32.1	34.8	37.4	41.2	43.6	49.0
RoAE (%)	43.2	38.7	34.3	33.7	32.3	35.2	38.1	42.4	45.4	51.5
12-month forward DCF value		**758**								
At RPM of 0.6										
EPS (Rs)	34.6	45.7	46.7	54.8	55.7	59.9	62.1	65.4	66.7	72.8
EPM (Rs)	0.32	0.31	0.27	0.27	0.27	0.27	0.27	0.27	0.27	0.27
RoACE (%)	32.1	31.4	25.8	26.8	26.2	28.3	30.2	33.2	35.4	39.9
RoAE (%)	43.2	38.7	28.2	27.2	26.3	28.6	30.7	34.0	36.4	41.4
12-month forward DCF value		**638**								
At RPM of Rs0.5										
EPS (Rs)	34.6	45.7	36.7	42.8	44.0	47.6	49.0	51.7	53.3	58.7
EPM (Rs)	0.32	0.31	0.22	0.22	0.23	0.23	0.23	0.23	0.22	0.22
RoACE (%)	32.1	31.4	**20.1**	**20.3**	**20.1**	**21.8**	**23.0**	**25.2**	**27.0**	**30.7**
RoAE (%)	43.2	38.7	21.8	20.7	20.1	21.9	23.2	25.6	27.6	31.5
12-month forward DCF value		**529**								

Source: Kotak Institutional Equities estimates.

Bharti's revenue per incremental minute declined substantially in the Sep '07 quarter

Bharti's revenue and EBITDA per incremental minute, 2QFY07-2QFY08

	Jun-06	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07
Revenues (Rs mn)	28,411	33,022	37,579	42,431	46,976	50,579
Total minutes of use (mn min)	28,194	33,844	41,305	49,240	57,125	64,375
Revenue per minute or RPM (Rs/min)	1.01	0.98	0.91	0.86	0.82	0.79
Incremental RPM (Rs/min)		**0.82**	**0.61**	**0.61**	**0.58**	**0.50**
EBITDA (Rs mn)	10,341	12,179	14,129	16,604	19,087	20,728
EBITDA per min or EPM (Rs/min)	0.37	0.36	0.34	0.34	0.33	0.32
Incremental EPM (Rs/min)		**0.33**	**0.26**	**0.31**	**0.31**	**0.23**

Source: Company data, Kotak Institutional Equities estimates.

Utilities

Sector coverage view	Neutral

		Price, Rs	
Company	Rating	19-Nov	Target
Tata Power	ADD	1,272	1,060
NTPC	ADD	266	215
Lanco	ADD	476	470
CESC	ADD	636	675

A beginning for merchant power

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- **Merchant power plants based on captive coal value accretive (P/B of 2.5X)**
- **Allocated reserves enough to power more than 18,000 MW of generation capacity**
- **15 coal blocks being allotted to 31 companies for captive mining for power projects**

The Ministry of Coal has begun allocating coal blocks based on the recommendations of the screening committee, which had recommended the allocation of 15 coal blocks reserved for the private sector to about 31 companies (discussed in our report *'Private players get coal, to play a larger role in generation capacity addition'* dated Oct 10, 2007). The 15 coal blocks to be allotted have reserves of around 3.5 bn tonnes, capable of generating about 18,000 MW of power. We believe most of this 18,000 MW of capacity addition will come in the form of merchant power plants given the low cost of generation and fuel security provided by captive coal blocks. Investment in merchant power plants based on captive coal blocks will likely result in value accretion of 1.5X equity investment (Rs12 mn/MW assuming a capex of Rs40 mn/MW and 80% debt financing). We have revised our target price for Tata Power to Rs1,060/share (Rs1,035 previously) and for Lanco Infratech to Rs470/share (Rs415 previously) based on value enhancement likely from merchant capacity additions.

Merchant power plants based on captive coal value accretive (P/B of 2.5X). Our DCF-to-equity model for merchant power plants, based on captive coal blocks, yields a P/B multiple of 2.5X equity invested. This implies value accretion of Rs12 mn/MW for an investment of Rs40 mn/MW and 80% debt financing. We have used a higher cost of equity (12.5%) to account for (1) the lack of firm purchase agreements and (2) variability in the actual project parameters as against our generic assumptions. We factor in merchant sale of power from the plants at a tariff of Rs2.25/unit over the 25 year estimated life of the project at 80% plant load factor. We assume the cost of coal mining at Rs700/ton for the first year and 3% annual inflation over the subsequent years. We note that value enhancement from merchant power plants is highly sensitive to (1) tariff for sale of power, (2) cost of coal mining and (3) plant load factor. The low cost of generation due to captive coal blocks will enable utility companies to sell the power on a merchant basis (under merit-order despatch as well) instead of assuring offtake through long-term power purchase agreements that yield predictable returns (14% regulated RoE).

Allocated reserves enough to power more than 18,000 MW of generation capacity. We believe private sector investment in generation will receive a major boost as getting the fuel linkage was a major bottleneck in the growth plans of most private power utilities. The 15 coal blocks allocated have an estimated reserves of around 3.5 bn tonnes, capable of firing about 18,000 MW of generation capacity.

We believe the fuel security and low cost of generation would prompt most companies to set up merchant power plants based on captive coal blocks.

15 coal blocks being allotted to 31 companies for captive mining for power projects. Media reports and announcements by utility companies suggest that 31 companies have been chosen for allocation of the 15 coal blocks reserved for the power sector. The 31 companies include—CESC, Essar Power, AES Chhattisgarh Energy Pvt. Ltd, Reliance Energy (Rosa Power), Adani Power, Tata Power, GMR Energy, Navabharat Power Pvt. Ltd of the Malaxmi Group, Lanco Infratech, Mittal Steel India Ltd, DB Power Ltd, Prakash Industries, Green Infrastructure Pvt. Ltd, RKM Powergen Pvt. Ltd, Visa Power, Vandana Vidyut Energy Ltd and Jas Infrastructure Capital Pvt. Ltd. Eight out of 15 blocks have been allotted on a sharing basis, while the remaining blocks have been given on a stand-alone basis.

Further media reports suggest that the Ministry of Coal has given the companies—to whom captive coal blocks have been allotted on a sharing basis—three options for carrying out mining operations at the allotted mines.

Option 1: Mining could be carried out by a consortium of two or more companies by constituting a special purpose vehicle (SPV). Consortium partners can have an equity stake and management participation and the coal would be distributed among them in proportion to their initial requirements at the time of allocation.

Option 2: One company would be designated the 'leader of the block' while the others would be termed 'associates'. The mining lease would be allocated to the leader while coal production would be distributed amongst all the companies.

Option 3: One company would be designated as the 'leader' to which the mining lease would be allocated while the remaining would be 'associates'. However under Option 3, distribution of the coal from the mines to the plants of the respective companies would be the responsibility of Coal India Ltd, through its subsidiary.

Revision in target prices. We have revised our target price to factor in Rs12 mn/MW enhancement in equity value from merchant based capacity addition. Accordingly we have factored in capacity addition for Tata Power (500 MW) and Lanco Infratech (1,000 MW) based on indicated capacity additions and suggested allocation of captive coal blocks. We have revised the target price for Tata Power to Rs1,060 (+ Rs26) and Lanco to Rs470 (+Rs54) respectively. We will further fine-tune our assumptions for value accretion based on detailed mining plans and project implementation schedules as and when these become available to us. We note that Tata Power has been allocated Mandakini coal block jointly with Jindal Photo (announced 600 MW) and Monnet Ispat. Lanco Infratech is sharing the Rampia and Dipside of Rampia coal blocks with five other players (GMR Energy, Mittal Steel, Sterlite Energy, Reliance Energy and Navbharat)—each one likely to implement a 1,000 MW power plant.

Merchant capacities estimated to result in equity enhancement of ~Rs12 mn/MW

Value enhancement from merchant capacities and revision of target price

	Tata Power	Lanco
Likely capacity addition (MW)	500	1,000
Project investment (Rs bn)	20	40
Equity investment (Rs bn)	4	8
Value enhancement (X)	1.5	1.5
Value enhancement (Rs bn)	6	12
Value enhancement (Rs/share)	**26**	**54**
Current target price (Rs/share)	1,035	415
Revised target price (Rs/share)	**1,060**	**470**

Source: Kotak Institutional Equities estimates.

Shareholder value accretion from a new merchant power project based on captive coal blocks is 1.5X
Detailed assumptions of DCF-to-equity model for merchant power plants based on captive coal

Capacity (MW)	1,000	Coal cost (first year)	700
PLF (%)	80	Coal cost escalation (%)	3
Life of plant (years)	25	Tariff (Rs/unit)	2.25
Total investment (Rs bn)	40	Construction period (months)	48
Debt: Equity	80:20	Debt repayment (years)	15
Free Cash Flow Analysis			
Cost of equity (%)	12.5	PV of FCFE (Rs bn)	11.80
Equity investment (Rs bn)	8.0	PV of terminal value (Rs bn)	0.41
		NPV (Rs bn)	12.21
IRR (%)			31.2
Shareholder value accretion (X)			**1.5**
P/B (X)			**2.5**

Source: Kotak Institutional Equities estimates.

Value accretion from merchant capacities is highly sensitive to tariff and PLF assumptions
Sensitivity of P/B (X) to tariff (Rs/unit) and PLF (%)

		Tariff (Rs/unit)				
		2	**2.25**	**2.5**	**2.75**	**3**
PLF (%)	**70**	1.7	2.4	3.2	3.9	4.6
	75	1.7	2.5	3.2	3.9	4.6
	80	1.8	2.5	3.3	4.0	4.7
	85	1.8	2.6	3.3	4.0	4.7
	90	1.9	2.6	3.4	4.1	4.8

Source: Kotak Institutional Equities estimates.

Lower cost of coal enables higher value accretion from merchant plants
Sensitivity of P/B (X) to tariff (Rs/unit) and coal cost (Rs/tonne) assumptions

		Tariff (Rs/unit)				
		2	**2.25**	**2.5**	**2.75**	**3**
Coal cost (Rs/tonne)	**600**	2.1	2.8	3.5	4.3	5.0
	650	1.9	2.7	3.4	4.1	4.8
	700	1.8	2.5	3.3	4.0	4.7
	750	1.6	2.4	3.1	3.8	4.6
	800	1.5	2.2	3.0	3.7	4.4

Source: Kotak Institutional Equities estimates.

Allocation of captive coal blocks (3.5 bn tonnes) will likely fuel generation capacity of 18,000 MW

Details of captive coal blocks allocated (mn tonnes)

Block	State	Coalfield	Geological reserves (mn tonnes)	Company
Seregarha	Jharkhand	North Karanpura	150	Mittal Steel, GVK Govidwal Sahib
Ganeshpur	Jharkhand	North Karanpura	138	Tata Steel, Adhunik Thermal energy
Amrakonda- Murgadangal	Jharkhand	Birbhum	411	JSPL, Gagan Sponge Iron
Mandakini	Orissa	Talcher	291	Tata Power, Jindal Photo, Monnet Ispat
Mahuagarhi	West Bengal	Rajmahal	220	CESC, Jas Infrastructure Capital
Fatehpur East	Chhattisgarh	Mand Raigarh	450	JLD Yavatmal Energy Ltd, Green infrastructure Pvt Ltd, RKM Powergen Pvt Ltd, Visa Power, Vandana Vidyut Energy
Fatehpur	Chhattisgarh	Mand Raigarh	120	SKS Ispat and Power, Prakash Industries
Rampia	Orissa	Ib River	285	Lanco, GMR Energy, Mittal Steel, Sterlite Energy, Reliance Energy, Navbharat
Dipside of Rampia	Orissa	Ib River	360	Lanco, GMR Energy, Mittal Steel, Sterlite Energy, Reliance Energy, Navbharat
Sayang	Chhattisgarh	Mand Raigarh	150	AES Chattisgarh energy
Lohara West and ext.	Maharashtra	Wardha Valley	169	UG mine -Adani Power
Durgapur II (Sariya)	Chhattisgarh	Mand Raigarh	92	UG mine - D B Power
Durgapur II (Taraimar)	Chhattisgarh	Mand Raigarh	211	UG mine - Balco
Gourangdih ABC	West Bengal	Raniganj	132	Himachal Emta Power, JSW Steel
Ashok Karkata Central	Jharkhand	North Karanpura	110	Essar Power
Patal East	Jharkhand	South Karanpura	200	UG mine - Bhushan Steel and Power
Total			**3,488**	

Source: Ministry of Coal, Company data, Media reports.

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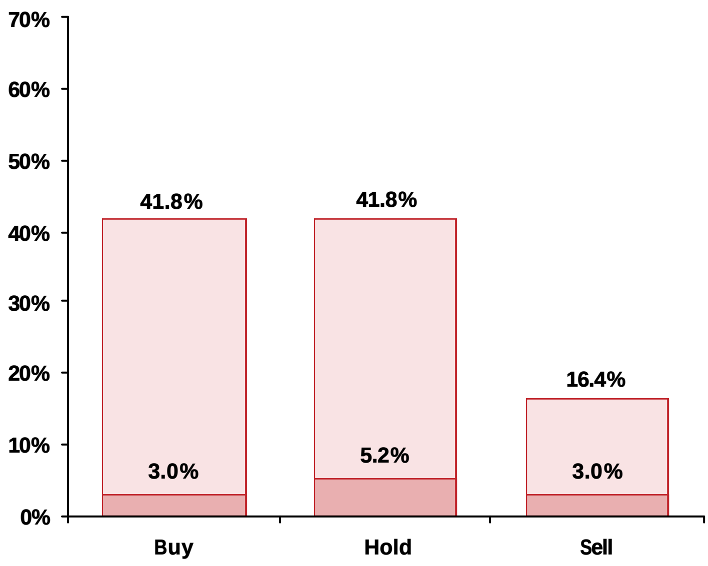

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Source: Kotak Institutional Equities. As of September 30, 2007

Ratings and other definitions/identifiers

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Old rating system

Definitions of ratings

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