kotak® Institutional Equities

INDIA DAILY

June 05, 2008

EQUITY MARKETS

India	4-Jun	1-day	1-mo	3-mo
		Change, %		
Sensex	15,515	(2.8)	(11.8)	(5.1)
Nifty	4,586	(2.8)	(12.3)	(5.7)
Global/Regional indices				
Dow Jones	12,403	(0.8)	(5.0)	1.5
Nasdaq Composite	2,480	(0.4)	0.1	9.7
FTSE	5,958	(1.7)	(4.1)	3.3
Nikkie	14,436	1.6	2.8	11.1
Hang Seng	24,123	(1.0)	(8.1)	4.3
KOSPI	1,834	0.8	(0.8)	9.4

Value traded - India

	4-Jun		1-mo	3-mo
			Moving avg, Rs bn	
Cash (NSE+BSE)	181.4		198.9	194.5
Derivatives (NSE)	404.5		363.0	366
Deri. open interest	676.8		676	645

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Corporate

- After the MTN debacle, Bharti Airtel Ltd, the country's largest mobile service provider, will no longer eye big acquisitions across the globe. In a change of strategy, the company will opt for the mobile virtual network operator (MVNO) model to increase its footprint overseas than outright acquisitions. (FE) Meanwhile, Reliance Communications, India's second-biggest mobile phone company, has hired Germany's Deutsche Bank as arranger to fund the possible acquisition of MTN Group. (BS)
- Outsourcing firm Integreon Managed Solutions has acquired Datum Legal, a litigation support firm based in New York, for an undisclosed sum. (ET)
- Nalco plans to invest about Rs40,000 crores in a host of greenfield and brownfield expansion projects, both within the country and abroad over the next 4-5 years. (ET)
- Enterprise resource planning software provider SAP said it may exceed the US$1 bn investment target for India as the business and market opportunity has grown multi-fold in the past few years.

Economic and political

- The government's price hike across petrol (Rs 5/liter), diesel (Rs3/liter) and LPG (Rs50/cylinder) dominates headlines and editorials across media this morning. Read our comments within for first-cut analyses of the impact of this development on the economy, markets and sectors.
- Telecom regulator Trai has sent its revised recommendations on satellite radio where it has recommended an FDI cap of 74% and a 4% revenue share for all players who want to offer services on this platform .(ET)

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

Forex/money market

	4-Jun	1-day	1-mo	3-mo
		Change, basis points		
Rs/US$	42.7	20	206	242
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	8.2	1	21	61

Net investment (US$mn)

	2-Jun		MTD	CYTD
FIIs	(87)		-	(3,485)
MFs	(37)		-	1,367

Top movers -3mo basis

Best performers	4-Jun	1-day	1-mo	3-mo
		Change, %		
Chambal Fert	79	(5.4)	12.0	48.0
Infosys	1,871	(2.7)	4.7	31.8
Nestle India	1,735	(0.8)	(0.6)	21.1
GESCO	480	(1.2)	9.7	20.0
Dr Reddy's	669	(3.8)	5.1	19.8
Worst performers				
Thermax	430	3.3	(14.1)	(34.7)
SAIL	154	(1.2)	(15.9)	(32.8)
Siemens India	515	(4.6)	(10.9)	(31.0)
Reliance Cap	1,068	(4.3)	(30.7)	(29.8)
BHEL	1,475	(4.8)	(22.8)	(29.7)

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Strategy

Sector coverage view	N/A

Fuel price increase will address subsidy issue partly; market offering good entry points in certain blue chip stocks

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- **Government addresses oil subsidy issue partly through a combination of price increase, tax cuts and oil bonds**
- **Buying opportunity emerging in certain blue chip stocks**
- **Moderate changes to our portfolio to factor in recent developments**

We see the moderate price hikes affected by the government on diesel (8%), gasoline (11%) and LPG (16%) addressing the oil subsidy issue partly. We compute a 0.9% increase in WPI and continued pressures on the government's fiscal position unless crude oil prices come down on a sustainable basis to around US$100/bbl. The government has also cut taxes (Rs227 bn revenue loss for the government; 3.3% of FY2009E gross tax revenues) and will provide oil bonds of Rs946 bn to the downstream oil companies to cover the estimated Rs2 tn of gross under-recoveries. Nonetheless, we believe the 11% correction and more in specific stocks over the past month provides good entry points into certain blue chip stocks. In particular, we do not see much downside in certain blue chip stocks such as BHEL, DLF, HDFC Bank, ICICI Bank, NTPC, ONGC, SBI and Tata Power, but see about 20% potential upside over the next 12-18 months. These stocks have come off significantly since January 2008 (see Exhibit 1).

Market offering good entry points in certain large-cap. stocks for investors with a 12-18-month investment horizon. We believe certain blue chip stocks are offering good entry points for investors looking at a 12-18-month horizon even though valuation of the broad market is still not very exciting, especially in light of our concerns about potential downgrades to earnings in several sectors. Exhibit 2 gives the valuation of the market on various parameters and Exhibit 3 presents valuation of the market broken down by sectors.

We believe the recent market correction offers an opportunity to change the portfolio towards large-cap. stocks, especially given the attractive valuations of some of them. We do not deny short-term problems, particularly in the banking and real estate sectors, but we think valuations of these high-quality companies adequately reflect short-term risks (higher interest rates). In any case, we do not expect the broad market to perform significantly over the next few months (-10% to +10% range, in our view); accordingly, we would advocate that investors realign their portfolios.

A few changes to the portfolio. We have made certain changes to our model portfolio to reflect (1) recent developments in the Indian oil and gas sector and (2) the savage correction in certain high-quality stocks over the past few days/weeks. We also make a few observations on certain other stocks, whose prices have come off without any major negative development.

1. **Increased weight on ONGC (BUY, TP: Rs1,200) to 4.5% from 0.8% previously.** We see the proposed changes by the government for the oil sector as a big positive for ONGC (rated BUY with 12-month target price of Rs1,200). The government has proposed the share of upstream companies at Rs450 bn out of total under-recoveries of Rs2 tn. This is a low figure versus street expectations and is a pleasant surprise; the street had feared a steep increase in the subsidy amount for upstream companies. As per the extant formula (1/3 for upstream companies), the share of upstream companies would have been around Rs660 bn). We find ONGC's valuations attractive at 6.4X FY2009E EPS (Rs140) especially as we have more confidence about our earnings forecasts. We had reduced weight on ONGC stock in early May and removed it out of then Top-10 list on fears of irrational government action (higher subsidy burden on upstream companies).

   In contrast, we would recommend investors to continue to avoid the downstream oil companies despite the price increase and other measures. The government's June 4, 2008 fiscal package will still leave the downstream oil companies exposed to potentially large losses. We note that the package leaves a gap of Rs419 bn out of the gross under-recoveries of Rs2 tn (see Exhibit 4). The government has placed Rs200 bn of net under-recoveries on the downstream oil companies, which is higher than the Rs161 bn figure for FY2008. We also note that FY2008 earnings of the oil companies benefited from strong refining margins, large adventitious (inventory) gains and high other income (appreciation in exchange rate, which resulted in foreign currency gains). We expect downstream oil companies' FY2009E earnings to be around FY2008 earnings.

2. **Made minor changes to few stocks to accommodate ONGC.** We have reduced Ranbaxy's weight to 0% although we still like the pharma sector and have a 6% weight versus the 2.2% weight of the sector in the BSE-30 Index. Ranbaxy stock has done remarkably well over the past six months but now offers 9% potential upside to our 12-month fair value of Rs565. We have reduced weights in Bharti, Reliance Industries, Reliance Infrastructure and Satyam by about 50-100 bps.

3. **Tata Power, Maruti are attractively valued at current levels.**

   a. Tata Power stock has declined 10% over the past two days without any real change in its fundamentals, in our view. We value Tata Power stock at Rs1,540 with about Rs490 coming from the value of its 30% investment in Bumi Resources (value of coal over and above 12 mtpa required for Mundra UMPP) and Rs387/share of cash and investments. Assuming our valuation of investments is correct, the stock is available at Rs288. Our FY2009E and FY2010E EPS estimates are Rs38 and Rs40; even taking out contribution from other income due to cash/investments, the stock is available at about 9X FY2009E EPS. Exhibits 5 and 6 give our SOTP-based valuation of Tata Power and our valuation exercise of its investment in Bumi Resources.

   b. Maruti stock has declined by 5% over the past two days led by concerns about higher fuel prices. However, we compute a 2.4% (Rs260 or US$6.2) increase in monthly cost of ownership arising from the Rs5/liter increase in petrol prices (see Exhibit 7). We do not view this as material enough to impact demand. We model Maruti's volumes to grow 14.6% (12.6% for domestic volumes) in FY2009E; its volumes have increased 19.7% yoy (18.2% domestic volumes) in the first two months.

Exhibit 8 gives our model portfolio and Exhibit 9 is our Top-10 list.

Certain blue-chip stocks are offering good entry points for investors willing to invest for a 12-18 months horizon

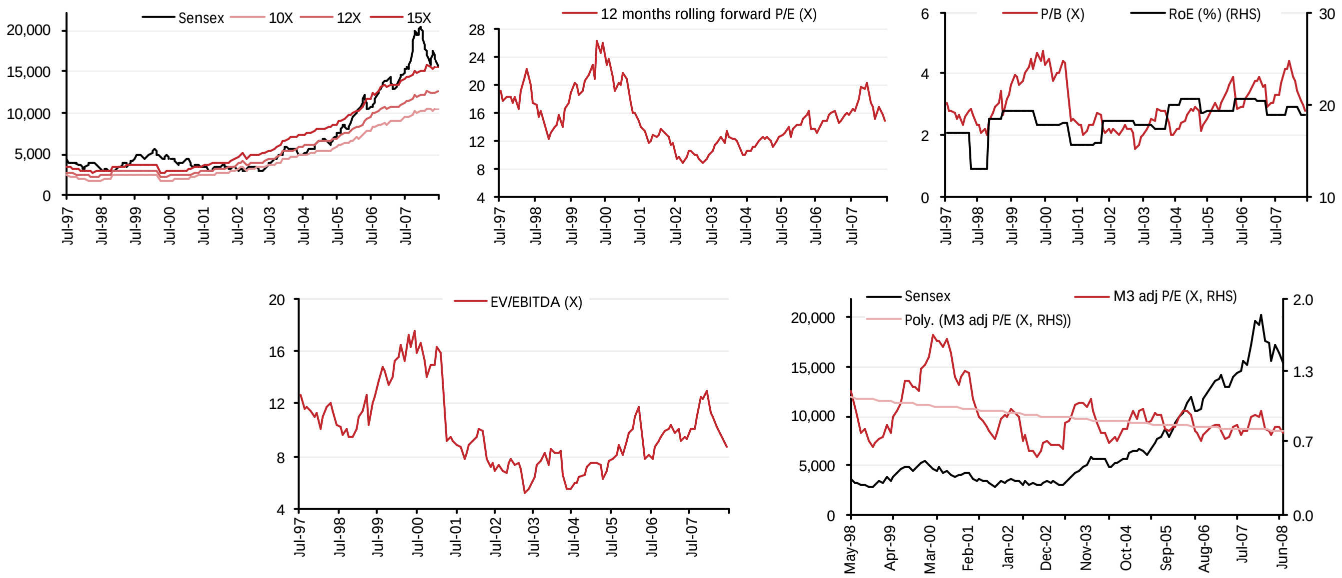
Performance of certain blue-chip stocks (%)

	Performance (%)				Price (Rs/share)			Discount to 52-w high
	1 month	3 months	1 year	YTD	4-Jun-08	52-w high	52-w low	(%)
Bharat Heavy Electricals	(22.8)	(29.7)	7.4	(43.0)	1,475	2,930	1,301	(49.7)
DLF	(23.2)	(18.1)	NA	(48.4)	554	1,225	490	(54.8)
HDFC Bank	(21.1)	(10.1)	4.0	(29.7)	1,215	1,825	1,050	(33.4)
ICICI Bank	(19.2)	(22.0)	(18.8)	(38.8)	758	1,465	720	(48.3)
NTPC	(21.4)	(17.2)	(1.7)	(37.1)	158	291	149	(45.8)
ONGC	(14.8)	(7.1)	(1.9)	(28.4)	886	1,387	768	(36.1)
State Bank of India	(27.0)	(29.0)	0.3	(40.5)	1,331	2,429	1,206	(45.2)
Tata Power	(18.1)	(5.7)	94.3	(20.8)	1,165	1,650	566	(29.4)
BSE-30 Index	**(11.8)**	**(5.1)**	**7.0**	**(23.5)**	**15,515**	**21,207**	**13,780**	**(26.8)**

Source: Bloomberg.

1-year rolling forward P/E has fallen from May 2008 levels

1-year rolling forward P/E, P/B, ROE, EV/EBITDA and M3 growth rate adjusted valuations



Source: BSE-30, Kotak Institutional Equities.

Valuation summary of BSE-30 sectors

	Mkt cap. (US$ mn)	Adj mkt cap. (US$ mn)	EPS growth (%)			PER (X)			EV/EBITDA (X)			Price/BV (X)			Div. yield (%)		RoE (%)		
			2008E	2009E	2010E	2008E	2009E	2010E	2008E	2009E	2010E	2008E	2009E	2010E	2008E	2009E	2008E	2009E	2010E
Automobiles	15,964	9,760	5.8	11.1	5.6	14.4	13.0	12.3	9.3	8.4	7.8	3.1	1.9	1.7	1.5	1.6	21.3	14.7	13.6
Banking	68,719	52,816	43.9	5.3	26.0	19.5	18.5	14.7	—	—	—	2.6	2.2	1.9	1.2	1.2	13.1	11.7	13.2
Cement	10,669	6,952	19.1	(1.6)	(4.6)	8.8	8.9	9.3	4.8	4.6	4.4	2.1	1.7	1.5	2.5	2.6	24.3	19.5	16.0
Consumers	30,878	19,249	15.1	13.2	15.6	26.7	23.6	20.4	18.9	15.0	12.8	9.2	8.1	7.0	2.8	2.5	34.4	34.1	34.2
Diversified	5,017	3,010	20.8	80.3	56.7	34.9	19.4	12.4	15.4	10.6	9.5	4.9	4.1	3.1	0.0	0.0	14.1	20.9	25.4
Energy	116,267	44,717	22.1	23.7	29.3	13.3	10.8	8.3	6.8	5.6	4.2	2.5	2.0	1.8	1.9	2.2	18.9	19.0	21.3
Industrials	36,276	23,278	25.1	35.1	27.2	30.0	22.2	17.4	16.3	12.5	9.9	6.7	4.9	3.9	0.7	0.9	22.5	22.3	22.6
Metals	22,010	15,407	(0.6)	26.5	(1.4)	13.5	10.7	10.9	7.8	6.5	6.6	1.9	1.6	1.5	1.3	1.3	14.0	15.3	13.4
Pharmaceuticals	8,370	5,669	23.9	1.1	25.1	24.3	24.0	19.2	16.8	16.6	13.6	5.2	4.6	4.0	1.5	1.8	21.3	19.1	20.9
Property	22,284	3,343	305.2	20.7	11.8	12.0	9.9	8.9	10.4	8.4	6.7	4.7	3.4	2.6	0.9	1.3	39.2	33.7	28.8
Technology	72,252	37,887	19.3	18.6	14.0	21.2	17.8	15.7	15.6	12.6	10.6	6.6	5.3	4.3	1.8	1.8	31.2	29.6	27.6
Telecom	62,324	21,813	71.6	30.4	22.7	21.2	16.3	13.3	13.3	9.7	7.7	5.2	4.0	3.1	0.2	0.4	24.5	24.4	23.7
Utilities	36,663	8,774	6.0	2.4	8.4	18.4	18.0	16.6	11.2	12.6	13.8	2.4	2.2	2.1	2.1	2.1	13.1	12.5	12.7
BSE-30	**507,694**	**252,675**	**29.6**	**18.6**	**19.8**	**17.3**	**14.6**	**12.2**	**10.1**	**8.6**	**7.2**	**3.4**	**2.8**	**2.4**	**1.5**	**1.6**	**19.6**	**18.9**	**19.5**
BSE-30 ex-Energy	**391,427**	**207,958**	**33.0**	**16.4**	**15.5**	**19.1**	**16.4**	**14.2**	**12.2**	**10.3**	**9.1**	**3.8**	**3.1**	**2.7**	**1.3**	**1.4**	**19.9**	**18.9**	**18.7**
BSE-30 ex-Energy, Com.	**358,747**	**185,599**	**38.4**	**16.8**	**18.3**	**20.3**	**17.4**	**14.7**	**13.6**	**11.3**	**9.7**	**4.2**	**3.4**	**2.9**	**1.3**	**1.4**	**20.5**	**19.3**	**19.6**

Note:
(a) EV/EBITDA excludes Banking sector.

Measures announed by government might not be sufficient given high under-recoveries
Impact of various measures announced and subsidy sharing for FY2009E (Rs bn)

Hike in retail price of gasoline, diesel and LPG	211
Savings from reduction in import and excise duty	227
Subsidy burden to be borne by upstream companies (ONGC, GAIL, OIL)	450
Oil bonds to be issued by the government	946
Net under-recoveries for downstream companies (BPCL, HPCL, IOCL)	200
Balance uncovered under-recoveries for the industry	**419**
Total under-recovery for the industry prior to price hike and duty cuts	**2,453**
Assumed crude price for computation of the above under-recovery (US$/bbl) (a)	**113**

Note:
(a) Price of Indian crude basket.

Source: Ministry of petroleum and natural gas, industry.

SOTP-based target price of Tata Power is Rs1540 per share
SOTP-based target price of Tata Power, March fiscal year-ends, 2009E basis (Rs mn)

	Value (Rs/share)	Methodology
Mumbai (generation, transmission & distribution business)	152	DCF-to-equity
Jojobera generation business	39	DCF-to-equity
Powerlinks Transmission Ltd.	14	Price/Book (x)
Delhi Distcom (NDPL)	25	DCF-to-equity
Tata BP Solar	66	EV/Sales (X)
Investments	323	Various
Investible surplus on books	64	Book value
Bumi Resources	490	Consensus
Mundra UMPP	144	DCF-to-equity
Maithon	28	DCF-to-equity
1,000 MW erchant plant based on captive coal blocks	26	DCF-to-equity
Value enhancement from future projects -assuming 50% probability	165	
Total	**1,536**	
Target price	**1,540**	

Source: Company data, Kotak Institutional Equities estimates.

Tata Power's stake in coal mines in Indonesia is valued at Rs490 per share

Valuation of TPC's stake in coal mines in Indonesia

Consensus target price (IDR)	**7,300**
Market cap. of Bumi Resources in USD bn (a)	**15.2**
Full value of coal resources - Arutmin and Kalimantan (b) = (a)/70%	21.7
FY2012 est. coal production at Arutmin and Kalimantan (mn tons)	100
TPC's economic share (30%)	30
TPC's requirement of imported coal (for Mundra UMPP)	12
TPC's net economic benefit from coal (mn tons)	18
TPC's net economic benefit from coal (%) (f)	**18**
Value of TPC stake (g) = (b)X(f)	3.9
Debt taken for acquisition of coal mines (US$ bn) (h)	1.1
Attributable equity value of coal mines for TPC = (g) - (h) (US$ bn)	2.8
Per share value (Rs)	**490**

Source: Bloomberg, Kotak Institutional Equities estimates.

Increase in petrol price by Rs5/litre results in 2.5% increase in car ownership cost

Impact of increase in petrol price on ownership cost of passenger cars

	Current	Increase in petrol price by Rs 5/litre	Increase in petrol price by Rs 10/llitre
Average on-road price of car inclusive of taxes (Rs)	250,000	250,000	250,000
% financing	90	90	90
Amount of loan (Rs)	225,000	225,000	225,000
Interest rate (%)	**11.0**	**11.0**	**11.0**
Tenure (years)	3	3	3
EMI (Rs)	7,366	7,366	7,366
Usage per day (km)	25	25	25
Mileage (km per litre)	12	12	12
Price of petrol (Rs per litre)	**50.5**	**55.5**	**60.5**
Fuel costs (Rs per month)	2,630	2,891	3,151
Annual maintenance costs (Rs)	10,000	10,000	10,000
Monthly maintenance costs (Rs)	833	833	833
Ownership cost (Rs per month)	**10,830**	**11,090**	**11,351**
% increase in car ownership cost		**2.4**	**4.8**

Source: Kotak Institutional Equities estimates.

Over-weighting Consumers and Pharmaceuticals
Kotak Institutional Equities Model Portfolio

Company	4-Jun Price (Rs)	Rating	Weightage (%) BSE-30	Weightage (%) KS reco.	Diff. (bps)
Mahindra & Mahindra	568	ADD	1.1	—	(109)
Maruti Suzuki	747	BUY	1.0	2.5	150
Tata Motors	541	SELL	1.8	—	(176)
Automobiles			**3.9**	**2.5**	**(136)**
State Bank of India	1,331	ADD	3.5	—	(353)
PSU Banking			**3.5**	**—**	**(353)**
HDFC	2,403	ADD	5.4	5.4	—
HDFC Bank	1,215	BUY	4.1	5.6	150
ICICI Bank	758	ADD	7.9	9.4	150
Pvt. Banking/Financing			**17.4**	**20.4**	**300**
ACC	633	REDUCE	0.7	—	(67)
Ambuja Cements	88	REDUCE	0.7	—	(68)
Grasim Industries	2,180	ADD	1.4	—	(140)
Jaiprakash Associates	198	BUY	1.2	1.2	—
Cement			**3.9**	**1.2**	**(275)**
Hindustan Unilever	230	ADD	2.3	2.3	—
ITC	216	BUY	5.3	8.3	300
Consumers			**7.6**	**10.6**	**300**
Oil & Natural Gas Corporation	886	BUY	3.5	4.5	100
Reliance Industries	2,307	RS	14.2	10.6	(354)
Energy			**17.7**	**15.2**	**(254)**
Bharat Heavy Electricals	1,475	ADD	2.4	—	(236)
Larsen & Toubro	2,756	BUY	6.9	8.9	200
Industrials			**9.2**	**8.9**	**(36)**
Hindalco Industries	178	ADD	1.5	—	(152)
Jindal Steel & Power	2,110	ADD	—	3.0	300
Tata Steel	814	ADD	4.6	4.6	—
Metals			**6.1**	**7.6**	**148**

Company	4-Jun Price (Rs)	Rating	Weightage (%) BSE-30	Weightage (%) KS reco.	Diff. (bps)
Cipla	208	REDUCE	1.0	—	(98)
Sun Pharmaceuticals	1,369	BUY	—	3.0	300
Ranbaxy Laboratories	519	BUY	1.3	—	(126)
Pharmaceuticals			**2.2**	**3.0**	**76**
DLF	554	BUY	1.3	2.8	150
Real estate		—	**1.3**	**2.8**	**150**
Infosys Technologies	1,871	BUY	8.5	10.3	175
Satyam Computer Services	486	BUY	2.9	2.9	—
TCS	957	REDUCE	2.2	—	(219)
Wipro	497	ADD	1.3	1.3	—
Technology		—	**15.0**	**14.6**	**(44)**
Bharti Airtel Limited	810	REDUCE	5.0	4.3	(75)
Reliance Communications	540	SELL	3.6	—	(361)
Telecom		—	**8.6**	**4.3**	**(436)**
Lanco Infratech	417	BUY	—	0.6	60
NTPC	158	ADD	1.8	1.8	—
Reliance Infrastructure	1,070	NR	1.6	1.6	—
Tata Power	1,165	ADD	—	2.0	200
Utilities		—	**3.5**	**6.1**	**260**
Biocon	461	BUY	—	0.6	60
Dishman Pharma & chemicals	319	BUY	—	0.6	60
Divi's Laboratories	1,441	BUY	—	0.6	60
Jubilant Organosys	340	BUY	—	0.6	60
Piramal Healthcare	369	BUY	—	0.6	60
Pharmaceutical mid-cap. basket		—	—	**3.0**	**300**
BSE-30	**15,515**	—	**100.0**	**100.0**	—

Note:
(1) Weights are with respect to June 4, 2008 prices.

Source: Bloomberg, BSE, Kotak Institutional Equities.

Biased towards solid long-term stocks
Kotak Institutional Equities Top-10 List

Companies	Sector	Rating	Mkt cap. (US$ mn)	CMP (Rs)	Target (Rs)	EPS (Rs) 2008E	EPS (Rs) 2009E	EPS (Rs) 2010E	P/E (X) 2008E	P/E (X) 2009E	P/E (X) 2010E	EV/EBDITA (X) 2008E	EV/EBDITA (X) 2009E	EV/EBDITA (X) 2010E
ITC	Consumer products	BUY	18,894	216	250	8.4	9.5	11.0	25.8	22.8	19.7	17.0	15.0	12.6
Larsen & Toubro	Industrials	BUY	19,081	2,756	3,600	77.9	116.7	148.9	35.4	23.6	18.5	19.6	14.2	11.1
ICICI Bank	Banking	ADD	19,730	758	933	39.9	35.4	46.2	19.0	21.4	16.4	—	—	—
DLF	Property	BUY	22,100	554	850	46.2	55.7	62.3	12.0	9.9	8.9	10.7	8.6	6.8
HDFC Bank	Banking	BUY	12,779	1,215	1,500	46.0	53.4	76.0	26.4	22.7	16.0	—	—	—
Maruti Suzuki	Automobiles	BUY	5,049	747	1,000	59.9	72.1	79.6	12.5	10.4	9.4	7.1	5.9	5.1
Jindal Steel and Power	Metals	ADD	7,601	2,110	2,900	80.4	111.6	117.0	26.2	18.9	18.0	16.4	12.2	11.1
Tata Power	Utilities	ADD	6,349	1,165	1,540	29.7	38.1	39.9	39.2	30.5	29.2	26.2	23.5	23.9
Sun Pharmaceuticals	Pharmaceuticals	BUY	6,663	1,369	1,720	71.5	86.7	73.7	19.2	15.8	18.6	15.6	12.3	13.3
Mid-cap. pharmaceutical basket														
Biocon	Pharmaceuticals	BUY	1,079	461	700	22.4	24.6	32.8	20.6	18.7	14.1	13.1	12.7	9.5
Dishman Pharma & Chemicals	Pharmaceuticals	BUY	608	319	515	14.9	20.5	27.1	21.4	15.6	11.8	15.8	11.0	8.7
Divi's Laboratories	Pharmaceuticals	BUY	2,177	1,441	1,915	51.4	65.9	95.7	28.0	21.9	15.1	22.9	17.5	11.9
Jubilant Organosys	Pharmaceuticals	BUY	1,442	340	530	22.8	23.7	27.9	14.9	14.4	12.2	11.9	11.2	8.8
Piramal Healthcare	Pharmaceuticals	BUY	1,805	369	470	17.6	21.9	26.7	21.0	16.9	13.8	15.2	11.8	9.4
BSE-30				**15,515**										

Source: Kotak Institutional Equities estimates.

Energy

ONGC.BO, Rs886	
Rating	BUY
Sector coverage view	Cautious
Target Price (Rs)	1,200
52W High -Low (Rs)	1387 - 768
Market Cap (Rs bn)	1,895

Financials

March y/e	2008	2009E	2010E
Sales (Rs bn)	1,105	1,348	1,313
Net Profit (Rs bn)	223.4	299.9	321.4
EPS (Rs)	104.4	140.2	150.3
EPS gth	*22.8*	*34.2*	*7.2*
P/E (x)	8.5	6.3	5.9
EV/EBITDA (x)	3.5	2.7	2.3
Div yield (%)	4.1	4.5	4.7

Shareholding, March 2008

	Pattern	% of Portfolio	Over/(under) weight
Promoters	74.1	-	-
FIIs	7.6	2.1	(3.4)
MFs	1.6	2.4	(3.1)
UTI	-	-	(5.5)
LIC	2.4	3.1	(2.4)

Oil & Natural Gas Corporation: Buy when there is a lot to gain

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- **Government subsidy package for FY2009E positive for ONGC's earnings and more important, for sentiment**
- **We assume higher subsidy loss for ONGC versus those implied by government package; earnings very strong still**
- **Revised fair value to Rs1,200 from Rs1,150 on rollover to FY2010E**

We see significant improvement in investment sentiment for ONGC stock consequent to the June 4, 2008 announcement of the government of India relating to (1) FY2009E subsidy loss of Rs450 bn for upstream, companies (although we suspect this number may be higher eventually), (2) increase in diesel, gasoline and LPG prices and (3) reduction in import duties on crude oil and products by 5% and excise duties on diesel and gasoline. We have revised ONGC's FY2009E and FY2010E EPS to Rs140 and Rs150 from Rs132 and Rs148 previously. We have revised our 12-month target price of ONGC stock to Rs1,250 (Rs1,150 previously) based on a normalized crude oil price of US$50/bbl equivalent to ONGC's net realization over the past few years versus our otherwise normalized crude price assumption of US$75/bbl (Dated Brent basis). Exhibit 1 gives our valuation table and Exhibit 2 gives the fair value of ONGC at various levels of the long-term (normalized) crude oil price. Key downside risk stems from higher-than-expected subsidy losses.

Government announcements a significant positive for ONGC; will likely improve sentiment for stock. We expect the government's announcements (see Exhibit 3 and 4) to result in improved sentiment for ONGC stock as we expect the market to increasingly accept the fact that the government may not increase the subsidy burden on ONGC irrationally and will contain it at a certain reasonable level. As of now, the government is leaving an unresolved amount of Rs419 bn and probably expects the gap to be met through (1) lower crude prices (likely, in our view), which will result in lower under-recoveries, (2) issue of more oil bonds (possible but depends on the government's fiscal position (already under severe pressure) and (3) higher retail price through another round of price increase (highly unlikely, in our view).

We do not rule out a higher subsidy burden for the upstream companies eventually or higher cess on crude oil (equivalent of windfall tax) to compensate for the loss of revenues to the government from the proposed reduction to import duty on crude oil and excise duty on diesel and gasoline. We are accordingly building in a more aggressive case for subsidy losses for ONGC for FY2009E; we assume Rs500 bn versus Rs380 bn implied by the Rs450 bn proposed share of upstream companies.

We would refer investors to our June 2 note titled *Buy when there is little to lose* for more details on the workings of the subsidy sharing scheme, implications for ONGC and various scenarios for ONGC (crude price and subsidy loss).

Key assumptions behind and changes to earnings model

1. **Subsidy loss.** We assume ONGC's FY2009E subsidy loss at Rs500 bn, which is significantly higher than the figure of around Rs380 bn implied by government's announced figure of Rs450 bn for upstream companies. We note that ONGC typically bears 84.5% of under-recoveries of upstream companies or about 28% of total under-recoveries (84.5% of 33.33%). Our assumed Rs500 bn subsidy loss for ONGC implies a subsidy loss of Rs1.78 tn for the industry, which seems more realistic, in our view. The government has projected gross under-recovery at Rs2 tn for FY2009E based on US$113/bbl India basket price (about US$118/bbl Dated Brent price).

At a Rs380 bn subsidy loss for FY2009E, ONGC's EPS would jump to Rs175. However, this would imply that the upstream companies bear about 22.5% of gross under-recoveries versus the historical figure of 33.33%. For FY2010E, we model subsidy loss for ONGC at Rs350 bn (unchanged) based on our crude price assumption of US$95/bbl (Dated Brent) and 33.33% sharing for upstream companies.

2. **Crude oil price.** We assume FY2009E Dated Brent crude price at US$110/bbl (US$100/bbl previously) and US$95/bbl (unchanged for FY2010E). Exhibit 5 gives sensitivity of ONGC's EPS to crude price and other key variables.
3. **Exchange rate.** We model the exchange rate at Rs42/US$ for FY2009E (Rs40/US$ previously) and Rs41/US$ for FY2010E (Rs39.5/US$ previously). We now have more clarity on India's overall BOP position and the weaker rupee reflects higher crude oil price assumption.
4. **Import duty on crude oil.** We have assumed 0% import duty on crude oil for the rest of FY2009E (5.15% before the revision to 0%) and beyond in line with the June 4, 2008 announcement. We have also made adjustments on import duty on products as per the changes made by the government.

We value ONGC stock at Rs1,200 on US$50/bbl normalized crude price

Estimation of fair value of ONGC stock based on normalized free cash flow (Rs mn)

	2009E	2010E	2011E
A. Core business valuation			
Normalized crude price assumption (US$/bbl)	50.0	50.0	50.0
Recurring operating cash flow			
Operating cash flow = EBIT X (1-t) + D	(67,626)	61,979	111,582
Add: OCF after normalizing natural gas price	35,113	27,087	23,736
Add: OCF after removing subsidies	361,178	252,656	211,073
Recurring OCF	328,665	341,722	346,392
Recurring capex			
Production per annum (mn bbls)	397	390	392
Replacement or F&D costs (US$/bbl)	9.0	9.0	9.0
Recurring capex	150,081	143,869	141,219
Free cash flow	**178,584**	**197,853**	**205,173**
Free cash flow multiple (X)	9	9	9
Enterprise value	1,607,252	1,780,674	1,846,558
(Net debt)/cash	394,475	551,368	734,264
Investments	90,514	95,457	100,398
Equity value	2,092,241	2,427,499	2,681,220
Equity value of core business (Rs/share)	**978**	**1,135**	**1,254**
B. New discoveries valuation			
KG-DWN-98/2 block (Rs/share)	49	55	62
MN-DWN-98/3 block (Rs/share)	15	16	18
Equity value of new discoveries (Rs/share)	**64**	**71**	**80**
Total equity value per share (Rs/share)	**1,042**	**1,206**	**1,333**

Source: Kotak Institutional Equities estimates.

ONGC's valuation is highly leveraged to normalised crude prices

Valuation sensitivity of ONGC to normalised crude price (Rs/share)

	Equity value (Rs/share)	Change from base case (%)
Normalized crude prices		
US$90/bbl	2,334	93
US$80/bbl	2,058	71
US$70/bbl	1,781	48
US$60/bbl	1,528	27
US$50/bbl	**1,206**	
US$45/bbl	1,069	(11)
US$40/bbl	895	(26)

Source: Kotak Institutional Equities estimates.

Government has announced a slew of measures to tackle the subsidy issue

Details of changes announed by the government

	Previous	Current
Prices related changes		
Retail price of gasoline (Rs/liter)	45.6	50.6
Retail price of diesel (Rs/liter)	31.8	34.8
Retail price of LPG (Rs/cylinder)	294.8	344.8
Duty related changes		
Excise duty on gasoline (Rs/liter)	14.9	13.9
Excise duty on diesel (Rs/liter)	4.7	3.7
Import duty on crude (%)	5.2	—
Import duty on gasoline and diesel (%)	7.7	2.6
Import duty on other petroleum products (%)	10.3	5.2

Source: Ministry of petroleum and natural gas, industry.

Measures announed by government might not be sufficient given high under-recoveries

Impact of various measures announced and subsidy sharing for FY2009E (Rs bn)

Hike in retail price of gasoline, diesel and LPG	211
Savings from reduction in import and excise duty	227
Subsidy burden to be borne by upstream companies (ONGC, GAIL, OIL)	450
Oil bonds to be issued by the government	946
Net under-recoveries for downstream companies (BPCL, HPCL, IOCL)	200
Balance uncovered under-recoveries for the industry	**419**
Total under-recovery for the industry prior to price hike and duty cuts	**2,453**
Assumed crude price for computation of the above under-recovery (US$/bbl) (a)	**113**

Note:
(a) Price of Indian crude basket.

Source: Ministry of petroleum and natural gas, industry.

ONGC's earnings are highly leveraged to crude prices
Earnings sensitivity of ONGC to key variables

	2009E			2010E			2011E		
	Downside	Base case	Upside	Downside	Base case	Upside	Downside	Base case	Upside
Exchange rate									
Rs/US$	41.0	42.0	43.0	40.0	41.0	42.0	39.0	40.0	41.0
Net profits (Rs mn)	282,912	299,860	316,794	305,779	321,389	336,990	327,341	343,010	358,673
Earnings per share (Rs)	132.3	140.2	148.1	143.0	150.3	157.6	153.0	160.4	167.7
% upside/(downside)	**(5.7)**		**5.6**	**(4.9)**		**4.9**	**(4.6)**		**4.6**
Average crude prices									
Crude price (US$/bbl)	108.0	110.0	112.0	93.0	95.0	97.0	88.0	90.0	92.0
Net profits (Rs mn)	287,306	299,860	312,403	308,358	321,389	334,412	329,536	343,010	356,477
Earnings per share (Rs)	134.3	140.2	146.1	144.2	150.3	156.3	154.1	160.4	166.7
% upside/(downside)	**(4.2)**		**4.2**	**(4.1)**		**4.1**	**(3.9)**		**3.9**
Cess									
Cess on domestic crude (Rs/ton)	3,090	2,575	2,060	3,090	2,575	2,060	3,090	2,575	2,060
Net profits (Rs mn)	291,437	299,860	308,283	312,808	321,389	329,971	334,313	343,010	351,707
Earnings per share (Rs)	136.3	140.2	144.1	146.2	150.3	154.3	156.3	160.4	164.4
% upside/(downside)	**(2.8)**		**2.8**	**(2.7)**		**2.7**	**(2.5)**		**2.5**
Natural gas prices									
Natural gas price ceiling (Rs/'000 cum)	3,750	4,250	4,750	4,250	4,750	5,250	4,500	5,000	5,500
Net profits (Rs mn)	294,241	299,860	305,474	316,061	321,389	326,712	337,785	343,010	348,230
Earnings per share (Rs)	137.6	140.2	142.8	147.8	150.3	152.7	157.9	160.4	162.8
% upside/(downside)	**(1.9)**		**1.9**	**(1.7)**		**1.7**	**(1.5)**		**1.5**

Source: Kotak Institutional Equities estimates.

Natural gas price increase and moderate volume growth are key earnings drivers
Key assumptions, March fiscal year-ends, 2006-2012E

	2006	2007	2008E	2009E	2010E	2011E	2012E
Rs/US$ rate	44.3	45.3	40.3	42.0	41.0	40.0	39.0
Subsidy share scheme loss (Rs bn)	119.6	170.2	200.0	500.0	350.0	290.0	290.0
Import tariff on crude oil (%)	5.1	5.1	5.2	0.9	—	—	—
Crude/natural gas prices							
Crude price							
Crude price, WTI (US$/bbl)			78.9	112.0	97.0	92.0	92.0
Crude price, Dated Brent (US$/bbl)	57.2	64.8	78.9	110.0	95.0	90.0	90.0
Net crude price, ONGC-India (Rs/ton)	10,390	10,692	11,107	9,058	9,609	9,870	9,251
Net crude price, ONGC-India (US$/bbl)	32.1	32.4	37.8	29.5	32.1	33.8	32.5
Natural gas price							
Ceiling natural gas price, India (Rs/cu m)	3.52	4.21	4.25	4.25	4.75	5.00	5.25
Ceiling natural gas price, India (US$/mn BTU)	2.12	2.49	2.82	2.70	3.10	3.34	3.60
Net natural gas price, ONGC-India (Rs/cu m)	3.11	3.76	3.79	3.79	4.24	4.47	4.69
Net natural gas price, ONGC-India (US$/mn BTU)	1.88	2.22	2.51	2.41	2.77	2.99	3.21
International operations							
Net natural gas price, OVL-Vietnam (Rs/cu m)	3.1	3.2	2.8	3.0	2.9	2.8	2.8
Net crude price, OVL-Sudan (Rs/ton)	8,118	9,384	10,142	14,710	12,415	11,480	11,193
Net crude price, OVL-Russia (Rs/ton)	8,320	9,633	10,434	15,177	12,795	11,826	11,530
Sales volumes—Domestic fields (a)							
Crude oil (mn tons)	22.5	24.4	24.2	25.0	25.0	24.9	24.8
Natural gas (bcm)	20.5	20.3	19.9	20.6	19.6	19.2	17.9
Sales volumes—Overseas fields							
Crude oil (mn tons)	4.6	5.8	7.8	8.8	8.6	8.6	8.6
Natural gas (bcm)	1.8	2.1	2.1	2.4	2.6	2.8	2.8
Total sales							
Crude oil (mn tons)	27.0	30.2	32.0	33.8	33.6	33.5	33.4
Natural gas (bcm)	22.3	22.5	22.0	23.0	22.2	22.0	20.7
Total sales (mn toe)	**46.9**	**50.3**	**51.7**	**54.4**	**53.4**	**53.2**	**51.9**
Total sales (mn boe)	**342**	**367**	**377**	**397**	**390**	**388**	**379**
Crude oil (%)	58	60	62	62	63	63	64
Natural gas (%)	42	40	38	38	37	37	36

(a) Includes ONGC's share of production from joint venture fields.

Source: Company data, Kotak Institutional Equities estimates.

Consolidated profit model, balance sheet, cash model of ONGC, March fiscal year-ends, 2006-2012E (Rs mn)

	2006	2007	2008E	2009E	2010E	2011E	2012E
Profit model (Rs mn)							
Net sales	807,603	968,227	1,105,143	1,347,882	1,313,321	1,348,132	1,347,501
EBITDA	**310,054**	**358,001**	**426,546**	**486,336**	**497,292**	**517,150**	**488,435**
Other income	27,350	45,377	38,683	46,897	57,772	57,772	58,272
Interest	(537)	394	(1,261)	(1,476)	(2,226)	(5,423)	(9,560)
Depreciation and depletion	(97,726)	(119,550)	(113,791)	(110,357)	(104,087)	(96,683)	(94,423)
Pretax profits	239,141	284,222	350,176	421,400	448,751	472,816	442,724
Tax	(71,196)	(88,987)	(114,560)	(128,960)	(134,929)	(131,159)	(123,911)
Deferred tax	(13,612)	(9,264)	(9,548)	11,960	10,120	2,477	4,352
Net profits	154,596	178,412	228,744	304,401	323,942	344,134	323,164
Net profits after minority interests	**153,542**	**176,921**	**225,134**	**299,860**	**321,389**	**343,010**	**323,247**
Earnings per share (Rs)	**71.8**	**82.7**	**105.3**	**140.2**	**150.3**	**160.4**	**151.1**
Balance sheet (Rs mn)							
Total equity	578,830	670,137	805,863	1,006,278	1,220,646	1,442,492	1,643,313
Deferred tax liability	71,557	80,976	90,524	78,564	68,445	65,968	61,616
Liability for abandonment cost	128,675	151,857	151,857	151,857	151,857	151,857	151,857
Total borrowings	28,767	21,826	34,254	41,427	77,054	117,454	157,854
Currrent liabilities	142,435	187,051	108,530	119,248	118,638	120,515	124,379
Total liabilities and equity	**950,264**	**1,111,847**	**1,191,028**	**1,397,375**	**1,636,639**	**1,898,286**	**2,139,019**
Cash	90,743	206,262	269,491	435,902	628,422	851,718	1,113,980
Current assets	240,210	192,652	210,647	228,857	225,689	234,077	237,038
Total fixed assets	565,722	643,219	641,177	662,902	707,874	732,897	708,406
Goodwill	14,172	27,686	27,686	27,686	27,686	27,686	27,686
Investments	35,753	36,888	36,888	36,888	41,828	46,769	46,770
Deferred expenditure	3,663	5,141	5,141	5,141	5,141	5,141	5,141
Total assets	**950,264**	**1,111,848**	**1,191,029**	**1,397,375**	**1,636,640**	**1,898,287**	**2,139,021**
Free cash flow (Rs mn)							
Operating cash flow, excl. working capital	216,736	252,772	252,988	303,095	312,753	342,911	320,673
Working capital changes	46,461	(4,990)	(91,516)	(53,161)	40,785	(3,069)	903
Capital expenditure	(113,738)	(135,049)	(52,874)	(81,491)	(104,098)	(87,288)	(38,938)
Investments	(28,912)	53,822	—	—	(4,940)	—	—
Other income	14,537	20,422	39,338	47,272	57,772	57,772	58,272
Free cash flow	**135,083**	**186,976**	**147,937**	**215,716**	**302,271**	**310,325**	**340,910**
Ratios (%)							
Debt/equity	5.0	3.3	4.3	4.1	6.3	8.1	9.6
Net debt/equity	(10.7)	(27.5)	(29.2)	(39.2)	(45.2)	(50.9)	(58.2)
RoAE	25.9	25.5	27.6	30.7	27.4	24.8	20.3
RoACE	**22.0**	**22.1**	**23.3**	**26.7**	**24.3**	**22.4**	**18.8**
Key assumptions							
Rs/dollar rate	44.3	45.3	40.3	42.0	41.0	40.0	39.0
Crude fob price (US$/bbl)	57.2	64.8	78.9	110.0	95.0	90.0	90.0
Ceiling/actual natural gas price (Rs/'000 cm)	3,515	4,211	4,250	4,250	4,750	5,000	5,250
Subsidy loss (Rs bn)	119.6	170.2	200.0	500.0	350.0	290.0	290.0

Source: Kotak Institutional Equities estimates.

Technology

WIPR.BO, Rs497	
Rating	ADD
Sector coverage view	Neutral
Target Price (Rs)	490
52W High -Low (Rs)	557 - 324
Market Cap (Rs bn)	720.8

Financials

March y/e	2008	2009E	2010E
Sales (Rs bn)	197.4	250.5	297.1
Net Profit (Rs bn)	32.2	39.8	45.7
EPS (Rs)	22.2	27.4	31.5
EPS gth	*12.6*	*23.3*	*14.8*
P/E (x)	22.4	18	15.8
EV/EBITDA (x)	17.9	13.3	10.9
Div yield (%)	1.3	1.6	1.9

Shareholding, March 2008

	Pattern	% of Portfolio	Over/(under) weight
Promoters	79.4	-	-
FIIs	6.8	0.6	(1.1)
MFs	0.4	0.2	(1.5)
UTI	-	-	(1.7)
LIC	1.1	0.4	(1.2)

Wipro: Priming itself for the big league. Key takeaways from analyst meet

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- **Priming itself for the big league—a long, challenging journey in our view**
- **Reorganized to sustain growth—responsibility sharing between joint CEOs not optimal**
- **Wipro Infotech to remain a strong growth driver**
- **Revenue growth to remain muted for the June and September quarters; reiterates confidence on recovery in 2HFY09**

Wipro management highlighted the various initiatives undertaken over the past few months to (1) strengthen the company's positioning as an end-to-end solutions provider and (2) become a transformation partner of choice. The top management emphasized the target of being amongst the top 10 IT/ITeS service providers globally in the next three to five years. Wipro has realigned its organization structure, made several leadership changes, and embarked on ambitious initiatives to unleash the potential in its comprehensive services portfolio and enhance its presence in the large/mega deals space. We were however disappointed with the limited discussion/emphasis on the changes in the sales and account management model, a significant area of weakness, in our view. We maintain our ADD rating with a target price of Rs490/share. The stock is trading at 18.1X FY2009E and 15.8X FY2010E earnings. Our EPS estimate would be 2.8% higher at Rs28.2 for FY2009E (Rs27.4 currently) and 9.3% higher for FY2010E to Rs34.4 (Rs31.5 currently) at the current Re/US$ rate of 42.5. Our current estimates are based on a Re/US$ rate of 39.5 for FY2009E and 38.5 for FY2010E.

Revenue growth to remain muted for the June and September quarters; reiterates confidence on recovery in 2HFY09: Consistent with its Tier-I peers, Wipro maintained its stance on muted revenue growth in the June and September quarters. The company also reiterated confidence of revenue growth recovery in the second half of the fiscal.

Reorganized to sustain growth. Wipro management indicated that the company has done significant restructuring along vertical/horizontal lines over the past few months with a focus on realizing the full potential of its wide array of service offerings. Key changes include (1) product engineering is now a horizontal; the service line teams have now merged with respective verticals, (2) pharmaceuticals sub-vertical, which was a part of manufacturing vertical earlier, has now been merged with the healthcare vertical, and (3) transportation and logistics, a part of the TMTS vertical earlier, has now been merged with the retail vertical. We note that the company has also done significant management realignment over the past few months though we believe that the structure for sharing of responsibility between the joint CEOs is not ideal.

Wipro Infotech merged with Global IT—WI's services business remains on a strong growth path. Wipro has integrated its WI business (India/Middle East) with its Global IT business to derive synergies from its Global IT service capabilities for the India/ME business. We note that WI services business has been on a strong growth path (revenue CAGR of 37% over the past three years) which the management expects to continue. We note that WI has recently closed three large deals—a US$600 mn 7-year deal with Aircel, a US$100-mn deal with Saudi Telecom, and a US$50 mn deal with the Future Group of India.

Priming itself for the big league—a long, challenging journey in our view. Wipro management reiterated its target of being among the top 10 IT/ITeS providers in the world over the next 3-5 years. The company highlighted some of the strategies/ initiatives that it has adopted/taken to achieve this.

- **Strengthening its presence in Total Outsourcing space.** Wipro has taken several steps over the past 12-18 months to enhance its capabilities and presence in the Total Outsourcing market. One of the key steps, in our view, was the acquisition of Infocrossing, a managed Data Center services provider in the US. Data Center capabilities are critical to large IT outsourcing deals.
- **Global Programs group.** Wipro has formed a new 'Global programs' group to focus on large deals in the market. The company defines a large deal as one with the potential to generate US$100 mn+ revenues over 5-7 years. The ex-head of BPO operations, T K Kurien, will head this group. The company has also hired experts (including investment bankers) on large deal structuring and pricing for the group.
- **Best shoring**. Over the past 24 months, Wipro has expanded its delivery capability geographically through both organic and inorganic expansion. The company now has 53 development centers worldwide.
- **Integrated Consulting group.** Wipro has pulled all its domain consultants from different verticals and put them in an integrated consulting group. The company indicates that the focus of this group would be to develop industry solutions and expects the group to drive CXO level relationships, critical for success large deals.
- **Mega partnerships**. Wipro continues to remain focused on strengthening its partnerships with top software/hardware providers of the world like Microsoft, Oracle, SAP, EMC, Cisco etc. The company indicated that these partnerships have played a major role in increasing Wipro's market share, especially in the emerging markets.
- **Leveraging R&D/Product Engineering strength.** Wipro has realigned Product Engineering from a vertical to a horizontal service line to better leverage its capabilities in newer verticals like automotives, aerospace, energy and utilities, retail, healthcare etc. We note that Wipro's R&D services business has been focused primarily on Telecom and Hi-tech verticals thus far.

We continue to like the full-service business model of the company and believe that it has the key ingredients in place (wide portfolio of service offerings, strong positioning in new service lines like infrastructure management, BPO, testing etc.) to catapult itself into the next level. However, improvement in account management model remains a work in progress, in our view; we would like to see improvement on this front. This reflects in weak client metrics—the company has only one US$100 mn+ account (TCS has 7, and Infosys 6). It also lags peers on US$50 mn+ accounts (Wipro has 14 compared to TCS' 19, and Infosys' 18).

Wipro: Profit & Loss Statement Statement (Consolidated US GAAP Statements)- March fiscal year ends

Rs mn	2007	2008	2009E	2010E
Revenues	**149,431**	**197,428**	**250,521**	**297,076**
Cost of revenues	(102,576)	(138,872)	(176,037)	(209,824)
Gross profit	**46,855**	**58,556**	**74,484**	**87,252**
Selling and marketing exp	(16,719)	(24,229)	(30,928)	(36,329)
EBIT (before amortization)	**30,136**	**34,327**	**43,556**	**50,923**
Amortization of Goodwill & Intangible Assets	(269)	(617)	(768)	(768)
EBIT (after amortization)	**29,867**	**33,710**	**42,788**	**50,155**
Other Income, net	2,667	2,167	2,456	2,791
PBT- before extraordinary items	**32,534**	**35,877**	**45,244**	**52,947**
Gain/(loss) on sale of stock of affiliate	-	-	-	-
PBT	**32,534**	**35,877**	**45,244**	**52,947**
Income Taxes	(4,423)	(3,873)	(5,767)	(7,598)
Income before share of equity in affiliates	**28,111**	**32,004**	**39,477**	**45,348**
Equity in earnings of affiliate	318	257	283	305
Minority Interest	-	(24)	-	-
Income from continuing operations	**28,429**	**32,237**	**39,759**	**45,654**
Income Tax Benefit	700	-	-	-
Adjustments	39	-	-	-
Net Profit- Reported	**29,168**	**32,237**	**39,759**	**45,654**
EPS (Rs/ share)	**19.7**	**22.2**	**27.4**	**31.5**
EPS (before amortization of intangibles)	**19.9**	**22.7**	**27.9**	**32.0**
Margins (%)				
Gross Profit margin	31.4	29.7	29.7	29.4
EBITDA Margin	22.8	20.1	20.0	19.7
EBIT Margin	20.0	17.1	17.1	16.9
NPM	19.0	16.3	15.9	15.4
Growth Rates (%)				
Revenues	40.8	32.1	26.9	18.6
Gross Profit	36.5	25.0	27.2	17.1
EBIT (before amortization & exchange gains)	34.9	13.9	26.9	16.9
EBIT (after amortization & exchange gains)	35.9	12.9	26.9	17.2
Income before affiliates earnings	40.6	13.8	23.3	14.9
Income from continuing operations	40.2	13.4	23.3	14.8

Source: Kotak Institutional Equities estimates.

Energy

Sector coverage view	Cautious

		Price, Rs	
Company	**Rating**	**4-Jun**	**Target**
IOC	REDUCE	418	460
BPCL	REDUCE	322	350
HPCL	REDUCE	241	260

BPCL, HPCL, IOCL: Government action bold in the circumstances but short of serving as a rerating trigger

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- **Government raises price of auto fuels and LPG and cuts duty rates**
- **Action not enough to improve sentiment for downstream oil companies**
- **Revised earnings estimates for BPCL, HPCL and IOCL**

The government announced a fiscal package for the oil sector for FY2009E, which we see as inadequate to forecast earnings of the downstream oil companies with confidence or to lead to improved investment sentiment for the sector. We note that the net under-recoveries of the downstream oil companies would be around Rs200 bn compared to Rs161 bn in FY2008 and pre-tax profits of Rs162 bn in FY2008E. However, the package still has a gap of Rs419 bn, which needs to be filled through subsequent government action or through lower global crude oil prices. If not, the amount of losses of the downstream oil companies may increase. Thus, we do not view the measures taken by the government as a trigger for re-rating of the downstream oil stocks. We have revised our earnings estimates to factor in the above-mentioned changes. We retain our REDUCE rating on the downstream oil companies given the high uncertainty of earnings. Key upside risks stem from lower-than-expected net under-recoveries due to steep decline in crude oil prices.

Government announces fiscal package for downstream companies for FY20009E. The government has announced the fiscal package for the downstream companies for FY2009E and decided to (1) increase retail prices of diesel (Rs3/liter), gasoline (Rs5/liter) and LPG (Rs50/cylinder), (2) issue oil bonds of Rs946 bn (Rs353 bn in FY2008) to the downstream oil companies, (3) reduce import tariffs on crude oil (to 0% from 5.15%), diesel and gasoline (to 2.6% from 7.7% previously) and other petroleum products (to 5.2% from 10.3%) and (4) reduce excise duty on diesel and gasoline by Re1/liter (Exhibit 1). Although this development highlights the government's willingness to protect earnings for downstream companies, we believe that it may not be sufficient in the current situation given likely very large amount of under-recoveries (Rs2 tn after factoring in price increase and duty reductions) led by record-high crude prices.

Further government action may be required in FY2009E. Exhibit 2 gives the impact of the changes announced by the government and the likely sharing of the subsidy burden between the upstream companies, downstream companies and the government. The government has computed a subsidy loss of Rs2.5 tn prior to price hike and duty cuts; this is based on crude price of US$113/bbl (India basket) or around US$118/bbl for Dated Brent. This figure compares with Rs771 bn of under-recovery in FY2008 and Rs494 bn in FY2007.

We believe that an increase in retail prices and cut in duties only partly alleviates the problem given the high level of under-recoveries; inspite of the measures announced by the government, there is still a gap of Rs419 bn, which needs to be covered. In our view, the government may need to (1) issue more oil bonds, (2) ask upstream companies to bear more subsidy burden versus the current proposed Rs450 bn and/or (3) increase retail prices further even if crude (Dated Brent) averages US$113/bbl for FY2009E.

Marketing losses decline for auto fuels and LPG, but still remain very high. The above-mentioned increase in prices and cut in import duty on auto fuels and LPG will result in additional revenues or savings of Rs211 bn and Rs227 bn for the downstream oil companies for the balance period of FY2009E. We compute marketing margins on diesel and gasoline to decline to –Rs17.4/liter and –Rs9.6/liter, respectively from –Rs22.8/liter and –Rs16.2/liter after the June 4, 2008 price increase. We compute marketing margins on LPG to decline to –Rs341/cylinder from –Rs389/cylinder previously. Exhibit 3 shows our computations of marketing margins for diesel, gasoline and LPG; we use international oil prices for the period May 2008 for our calculations of marketing margins. The marketing losses on auto fuels and cooking fuel continue to be very high even after the hike in auto fuel prices.

Key changes to and major assumptions behind earnings model

We discuss our key assumptions and the major changes to our earnings model for BPCL, HPCL and IOCL. Exhibit 5 gives our revised EPS estimates for BPCL, HPCL and IOCL for FY2009E and FY2010E

1. **Compensation (oil bonds) from the government.** We assume the government will issue oil bonds of Rs1.1 tn bn (up from Rs855 bn assumed previously) and versus Rs946 bn announced currently, Rs935 bn (775 bn) and Rs545 bn (Rs545 bn) for FY2009E, FY2010E and FY2011E, respectively to the state-owned R&M companies compared to Rs353 bn of oil bonds issued in FY2008. Although the government has announced an issue of oil bonds for Rs946 bn for FY2009E, we believe that it would not be sufficient to cover the under-recoveries; it would still leave a gap of Rs419 bn to be covered. In our view, the government will likely issue more oil bonds for the same or force the upstream companies to bear more subsidies. We rule out further price increases given political issues.
2. **Changes in import tariffs.** We have made changes to factor the changes announced by the government in the import tariff structure. We have reduced import tariffs on crude oil (to 0% from 5.15%), diesel and gasoline (to 2.6% from 7.7% previously) and other petroleum products (to 5.2% from 10.3%).
3. **Exchange rate.** We have revised our rupee-dollar exchange rates for FY2009E, FY2010E and FY2011E to Rs42/US Dollar, Rs41/US Dollar and Rs40/US Dollar, respectively compared to Rs40/US Dollar, Rs39.5/US Dollar and Rs39/US Dollar, respectively, previously.

Government has announced a slew of measures to tackle the subsidy issue
Details of changes announed by the government

	Previous	Current
Prices related changes		
Retail price of gasoline (Rs/liter)	45.6	50.6
Retail price of diesel (Rs/liter)	31.8	34.8
Retail price of LPG (Rs/cylinder)	294.8	344.8
Duty related changes		
Excise duty on gasoline (Rs/liter)	14.9	13.9
Excise duty on diesel (Rs/liter)	4.7	3.7
Import duty on crude (%)	5.2	—
Import duty on gasoline and diesel (%)	7.7	2.6
Import duty on other petroleum products (%)	10.3	5.2

Source: Ministry of petroleum and natural gas, industry.

Measures announed by government might not be sufficient given high under-recoveries
Impact of various measures announced and subsidy sharing for FY2009E (Rs bn)

Hike in retail price of gasoline, diesel and LPG	212
Savings from reduction in import and excise duty	227
Subsidy burden to be borne by upstream companies (ONGC, GAIL, OIL)	450
Oil bonds to be issued by the government	946
Net under-recoveries for downstream companies (BPCL, HPCL, IOCL)	200
Balance uncovered under-recoveries for the industry	**419**
Total under-recovery for the industry prior to price hike and duty cuts	**2,453**
Assumed crude price for computation of the above under-recovery (US$/bbl) (a)	**113**

Note:
(a) Price of Indian crude basket.

Source: Ministry of petroleum and natural gas, industry.

Marketing losses on diesel and gasoline to decline after recent increase in retail fuel prices

Calculation of marketing margins/subsidy of key products

	Prior to price hike	Post price hike
May 2008 exchange rate (Rs/US$)	42.1	42.1
International price (US$/ton) (a)		
Gasoline	1,086	1,086
Diesel	1,172	1,172
LPG	871	871
Import duty (%)		
Gasoline	7.7	2.6
Diesel	7.7	2.6
LPG	—	—
India IPP price (incl. transport) (a)		
Gasoline (Rs/liter)	37.9	36.5
Diesel (Rs/liter)	45.3	43.6
LPG (Rs/cylinder)	621	621
India retail price without taxes		
Gasoline (Rs/KL)	21,713	26,915
Diesel (Rs/KL)	22,457	26,158
LPG (Rs/cylinder)	16,304	19,690
India retail price without taxes		
Gasoline (Rs/liter)	21.7	26.9
Diesel (Rs/liter)	22.5	26.2
LPG (Rs/cylinder)	231.5	279.6
Marketing margin or subsidy		
Gasoline (Rs/liter)	**(16.2)**	**(9.6)**
Diesel (Rs/liter)	**(22.8)**	**(17.4)**
LPG (Rs/cylinder)	**(389.4)**	**(341.3)**

Note:
(a) International price for May, 2008.
(b) Selling prices include transport costs estimated at Rs1.2/l for diesel and Rs1.3/l for gasoline.

Source: Industry data, Kotak Institutiional Equities estimates.

Reduction in duty on crude as well as petroleum products to result in higher overall tariff protection

Import tariffs on oil products, March fiscal year-ends, 2005-2010E (%)

	2005	2006	Mar-07	2007	2008	Jun-08	2009E	2010E
LPG	6.6	—	—	—	—	—	—	—
Gasoline	16.7	10.2	7.7	8.1	7.7	2.6	3.5	2.6
Naphtha	7.6	4.7	—	—	—	—	—	—
Kerosene	6.6	—	—	—	—	—	—	—
ATF	19.4	10.2	10.3	10.2	10.3	5.2	6.1	5.2
Diesel	16.7	10.2	7.7	8.1	7.7	2.6	3.5	2.6
FO	19.4	10.2	10.3	10.2	10.3	5.2	6.1	5.2
Bitumen	19.4	10.2	10.3	10.2	10.3	5.2	6.1	5.2
Weighted average import duty	**14.5**	**7.9**	**6.1**	**6.2**	**6.1**	**2.4**	**3.1**	**2.4**
Duty on crude	10.2	5.1	5.2	5.1	5.2	—	—	—
Tariff differential	**4.4**	**2.8**	**0.9**	**1.1**	**0.9**	**2.4**	**3.1**	**2.4**

Source: Kotak Institutional Equities estimates.

Revision in earnings estimates for BPCL, HPCL and IOCL, March fiscal year-ends, 2009-2010E

	BPCL		HPCL		IOCL	
	2009E	2010E	2009E	2010E	2009E	2010E
EBITDA (Rs mn)						
New	31,453	35,978	36,754	45,109	113,159	134,255
Old	29,717	33,266	33,847	41,238	113,150	131,213
Change (%)	**5.8**	**8.2**	**8.6**	**9.4**	**0.0**	**2.3**
EPS (Rs/share)						
New	39.7	39.7	35.8	33.5	42.7	61.9
Old	39.1	38.8	34.3	32.3	44.9	60.8
Change (%)	**1.5**	**2.4**	**4.3**	**4.0**	**(4.7)**	**1.8**

Source: Kotak Institutional Equities estimates.

Consolidated profit model, balance sheet, cash model of BPCL, March fiscal year-ends, 2004-2011E (Rs mn)

	2004	2005	2006	2007	2008E	2009E	2010E	2011E
Profit model (Rs mn)								
Net sales	479,840	578,774	755,333	965,569	1,200,717	1,545,809	1,556,100	1,596,017
EBITDA	**38,686**	**26,231**	**9,407**	**35,362**	**44,138**	**31,453**	**35,978**	**45,771**
Other income	4,348	4,015	4,653	7,332	11,794	9,120	19,301	24,143
Interest	(1,447)	(1,748)	(2,474)	(4,774)	(5,658)	(9,133)	(22,898)	(35,432)
Depreciation	(6,754)	(7,130)	(7,680)	(9,041)	(10,437)	(9,672)	(10,636)	(11,596)
Pretax profits	34,833	21,368	3,906	28,879	39,837	21,768	21,744	22,886
Extraordinary items	(420)	810	176	(68)	1,279	—	—	—
Tax	(12,026)	(7,250)	(140)	(9,286)	(11,390)	(6,108)	(4,707)	(6,391)
Deferred taxation	(805)	(1,230)	(1,025)	(268)	(1,471)	(1,291)	(2,684)	(1,388)
Net profits	21,582	13,698	2,916	18,055	28,256	14,369	14,353	15,107
Net profits after minority interests	**19,086**	**11,334**	**2,916**	**18,055**	**28,256**	**14,369**	**14,353**	**15,107**
Earnings per share (Rs)	**64.6**	**37.2**	**7.6**	**50.1**	**75.6**	**39.7**	**39.7**	**41.8**
Balance sheet (Rs mn)								
Total equity	69,960	82,887	91,394	102,735	119,147	127,493	135,830	144,605
Deferred taxation liability	11,304	12,533	13,558	13,826	15,297	16,588	19,273	20,661
Total borrowings	32,701	46,589	83,736	108,292	84,666	155,166	447,666	472,166
Currrent liabilities	95,495	104,462	94,070	112,767	100,667	119,666	121,167	126,191
Total liabilities and equity	**209,459**	**246,472**	**282,758**	**337,620**	**319,777**	**418,914**	**723,936**	**763,623**
Cash	9,319	6,644	4,921	8,640	5,062	5,199	5,159	7,176
Current assets	97,729	130,393	128,208	127,698	121,397	153,258	153,635	157,406
Goodwill	—	—	—	—	—	—	—	—
Total fixed assets	88,484	98,542	110,855	118,334	132,716	144,854	159,540	158,438
Investments	13,927	10,893	38,774	82,949	60,602	115,602	405,602	440,602
Total assets	**209,459**	**246,472**	**282,758**	**337,621**	**319,777**	**418,914**	**723,936**	**763,623**
Free cash flow (Rs mn)								
Operating cash flow, excl. working capital	30,727	21,118	9,275	29,920	26,380	16,212	8,373	3,948
Working capital	1,025	(18,393)	1,577	11,451	(2,911)	(14,566)	2,314	2,560
Capital expenditure	(17,001)	(17,120)	(19,945)	(17,908)	(22,828)	(21,810)	(25,322)	(10,494)
Investments	1,278	2,992	(28,146)	(45,481)	22,347	(55,000)	(290,000)	(35,000)
Other income	1,985	2,445	1,785	4,337	8,905	10,824	18,111	22,835
Free cash flow	**18,015**	**(8,957)**	**(35,455)**	**(17,682)**	**31,892**	**(64,340)**	**(286,524)**	**(16,150)**
Ratios (%)								
Debt/equity	40.2	48.8	91.6	105.4	71.1	121.7	329.6	326.5
Net debt/equity	28.8	41.9	86.2	97.0	66.8	117.6	325.8	321.6
RoAE	28.8	14.4	3.3	16.3	22.5	10.3	9.6	9.4
RoACE	**21.2**	**12.0**	**4.1**	**11.0**	**14.8**	**8.6**	**7.8**	**6.8**
Key assumptions (standalone until FY2005)								
Crude throughput (mn tons)	8.8	9.1	17.2	19.8	20.9	21.0	21.5	23.0
Effective tariff protection (%)	7.2	4.8	2.9	1.6	1.4	2.4	2.6	2.6
Net refining margin (US$/bbl)	4.2	3.8	2.1	3.2	5.2	4.2	3.4	4.0
Sales volume (mn tons)	20.9	21.5	23.3	24.2	26.4	27.4	28.5	29.6
Marketing margin (Rs/ton)	1,893	1,732	(671)	(1,140)	(2,983)	(13,536)	(10,127)	(3,691)
Subsidy under-recoveries (Rs mn)	(13,518)	(25,821)	(31,847)	(20,159)	(28,131)	(27,791)	(14,113)	(8,152)

Source: Kotak Institutional Equities estimates.

Profit model, balance sheet, cash model of HPCL, March fiscal year-ends, 2004-2011E (Rs mn)

	2005	2006	2007	2008E	2009E	2010E	2011E
Profit model (Rs mn)							
Net sales	597,020	708,609	889,959	1,067,743	1,378,317	1,381,280	1,391,037
EBITDA	**20,511**	**8,056**	**24,036**	**15,540**	**36,754**	**45,109**	**51,180**
Other income	3,295	3,285	6,845	11,980	16,279	26,292	30,713
Interest	(816)	(1,587)	(4,230)	(7,925)	(24,211)	(44,152)	(53,670)
Depreciation	(6,584)	(6,902)	(7,040)	(8,508)	(10,438)	(10,023)	(10,758)
Pretax profits	16,406	2,851	19,611	11,087	18,384	17,226	17,465
Extraordinary items	1,471	2,201	3,030	—	—	—	—
Tax	(5,897)	(898)	(6,625)	(1,799)	(2,219)	(4,329)	(4,284)
Deferred taxation	793	(97)	(365)	(2,025)	(4,029)	(1,526)	(1,653)
Prior period adjustment	—	—	61	4,086	—	—	—
Net profits	**12,773**	**4,056**	**15,712**	**11,349**	**12,135**	**11,371**	**11,529**
Earnings per share (Rs)	**34.8**	**6.6**	**40.0**	**33.5**	**35.8**	**33.5**	**34.0**
Balance sheet (Rs mn)							
Total equity	84,409	87,357	95,987	106,146	111,143	115,825	120,573
Deferred tax liability	13,748	13,844	14,209	16,234	20,263	21,789	23,442
Total borrowings	21,854	66,638	105,175	189,175	407,425	558,425	597,925
Currrent liabilities	69,887	79,549	101,195	92,812	112,482	115,827	115,287
Total liabilities and equity	**189,896**	**247,389**	**316,566**	**404,368**	**651,314**	**811,866**	**857,227**
Cash	2,016	426	868	1,224	2,225	2,458	3,172
Current assets	93,007	109,674	113,779	134,210	171,369	173,565	173,277
Total fixed assets	77,305	97,013	130,644	148,636	157,421	165,545	170,480
Investments	17,568	40,276	71,275	120,298	320,298	470,298	510,298
Total assets	**189,896**	**247,389**	**316,566**	**404,368**	**651,314**	**811,867**	**857,227**
Free cash flow (Rs mn)							
Operating cash flow, excl. working capital	15,977	10,126	23,966	6,334	8,561	(3,996)	(6,773)
Working capital changes	(3,614)	(5,351)	8,936	(26,222)	(19,166)	2,364	964
Capital expenditure	(12,849)	(25,298)	(38,510)	(22,932)	(17,461)	(17,523)	(15,693)
Investments	2,995	(22,884)	(31,704)	(49,023)	(200,000)	(150,000)	(40,000)
Other income	800	941	2,067	9,389	17,955	25,076	29,497
Free cash flow	**3,310**	**(42,466)**	**(35,246)**	**(82,454)**	**(210,111)**	**(144,079)**	**(32,005)**
Ratios (%)							
Debt/equity	22.3	65.8	95.4	154.6	310.1	405.8	415.2
Net debt/equity	20.2	65.4	94.7	153.6	308.4	404.0	413.0
RoAE	13.4	4.1	14.9	9.8	9.6	8.5	8.2
RoACE	**10.1**	**2.5**	**8.8**	**6.0**	**8.8**	**7.4**	**7.5**
Key assumptions							
Crude throughput (mn tons)	13.9	14.0	16.7	16.8	18.3	19.3	19.3
Effective tariff protection (%)	5.6	3.1	1.4	1.2	2.8	2.6	2.6
Net refining margin (US$/bbl)	4.5	3.9	4.3	6.2	5.3	4.7	4.7
Sales volume (mn tons)	20.6	20.1	23.4	24.8	25.6	26.5	27.4
Marketing margin (Rs/ton)	1,688	(463)	(710)	(2,476)	(11,783)	(8,902)	(3,206)
Subsidy under-recoveries (Rs mn)	(26,708)	(29,671)	(18,899)	(25,359)	(20,218)	(8,495)	(8,564)

Source: Kotak Institutional Equities estimates.

Consolidated profit model, balance sheet, cash model of IOCL, March fiscal year-ends, 2004-2010E (Rs mn)

	2004	2005	2006	2007	2008E	2009E	2010E
Profit model (Rs mn)							
Net sales	1,173,450	1,379,018	1,729,474	2,149,428	2,732,553	3,505,453	3,537,952
EBITDA	**114,303**	**86,765**	**82,044**	**110,451**	**121,076**	**113,159**	**134,255**
Other income	17,565	16,138	21,310	27,451	43,025	38,016	87,132
Interest	(5,043)	(7,433)	(12,101)	(17,058)	(18,110)	(40,626)	(75,951)
Depreciation	(20,626)	(23,140)	(24,711)	(28,686)	(29,918)	(32,469)	(34,578)
Pretax profits	106,199	72,330	66,542	92,157	116,073	78,080	110,858
Extraordinary items	3,553	4,283	5,590	24,757	5,374	6,359	6,304
Tax	(25,966)	(13,658)	(19,975)	(25,834)	(38,236)	(25,344)	(34,361)
Deferred taxation	(5,157)	(2,335)	(1,282)	(8,040)	(473)	(613)	(2,718)
Net profits	79,052	59,475	51,125	82,729	82,858	58,483	80,083
Net profits after minority interests	**73,298**	**52,666**	**45,362**	**62,469**	**74,016**	**50,964**	**73,777**
Earnings per share (Rs)	**62.8**	**45.1**	**38.8**	**52.4**	**62.1**	**42.7**	**61.9**
Balance sheet (Rs mn)							
Total equity	233,386	271,302	317,977	378,117	449,555	498,200	568,394
Deferred tax liability	47,934	50,367	50,602	59,859	60,331	60,944	63,662
Total borrowings	146,147	197,809	292,395	290,215	418,813	957,042	1,400,846
Currrent liabilities	219,522	266,430	286,716	330,791	390,802	476,065	484,029
Total liabilities and equity	**646,988**	**785,907**	**947,691**	**1,058,981**	**1,319,502**	**1,992,251**	**2,516,931**
Cash	13,777	13,356	8,080	9,385	4,603	3,512	4,179
Current assets	278,550	368,158	413,904	437,178	605,766	760,241	768,043
Total fixed assets	320,647	370,003	383,717	415,014	428,025	447,390	463,601
Investments	34,013	34,391	141,990	197,403	281,108	781,108	1,281,108
Total assets	**646,988**	**785,907**	**947,691**	**1,058,981**	**1,319,502**	**1,992,250**	**2,516,931**
Free cash flow (Rs mn)							
Operating cash flow, excl. working capital	93,713	71,765	(10,334)	(44,660)	56,212	43,678	28,641
Working capital changes	1,710	(33,421)	(8,136)	2,237	(84,561)	(68,779)	2,342
Capital expenditure	(47,179)	(73,626)	(49,042)	(50,969)	(41,972)	(51,148)	(44,373)
Investments	(509)	(1,172)	(17,778)	99,768	(83,705)	(499,885)	(500,000)
Other Income	5,826	7,814	10,317	13,582	13,451	68,575	64,042
Free cash flow	**53,560**	**(28,641)**	**(74,973)**	**19,958**	**(140,574)**	**(507,559)**	**(449,349)**
Ratios (%)							
Debt/equity	52.0	61.5	79.3	66.3	82.1	171.2	221.6
Net debt/equity	47.1	57.3	77.1	64.1	81.2	170.5	221.0
RoAE	30.0	18.3	13.7	16.1	16.2	9.9	12.9
RoACE	**20.4**	**13.7**	**9.3**	**11.3**	**10.9**	**6.6**	**7.3**
Key assumptions (IOC standalone)							
Crude throughput (mn tons)	37.7	36.6	38.5	44.0	47.4	48.4	49.9
Effective tariff protection (%)	7.9	5.8	3.3	1.9	1.7	2.5	2.7
Net refining margin (US$/bbl)	5.4	6.2	4.8	4.9	8.9	7.2	6.3
Sales volume (mn tons)	47.1	48.2	50.4	53.4	57.4	59.6	61.5
Marketing margin (Rs/ton)	2,092	1,982	26	(633)	(1,690)	(11,395)	(8,326)
Subsidy under-recoveries (Rs mn)	(28,078)	(64,309)	(95,361)	(34,041)	(40,937)	(74,198)	(19,879)

Source: Kotak Institutional Equities estimates.

Economy

Sector coverage view	N/A

Economy stung, but takes oil shock on the chin

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- **Fuel price hike to raise WPI by 0.9 pps immediately; 1.5 ppt in total**
- **Move to save Rs 438 bn in oil bond issuance—not relevant for interest rates**
- **FRBM rules set to be violated, GFD/GDP ratio may rise to 4.8% at the outside**
- **Central bank holds trump cards—can stabilize interest rates and exchange rate**

Inertia gave way to policy action at last with the government swallowing the bitter pill of raising domestic fuel prices. Our quantitative analysis suggests that the action would immediately raise the WPI by 0.9 pps and headline inflation would be near 10% for the week-ended June 7. While plenty of worries prevail, we believe that the central bank holds the trump cards and can step in to stabilize interest rates and the exchange rate through its special market operations or other policy actions.

Inflation hike gets front-loaded; may push inflation to about 10% in June 2008

We expect the headline inflation rate for the week-ended June 7, 2007 to rise to around 10% as a result of the fuel price hike (Rs5/litre for petrol, Rs.3/litre for diesel and Rs50/cylinder for LPG). If one takes the average long-term increase of 0.1% per week in WPI, headline inflation, inclusive of the impact of the fuel price hike, works out to 9.67%. However, with current inflationary pressures, it is possible that this may actually breach the 10% mark.

Our estimates of the inflationary impact of fuel price hike, in brief

- Immediate direct impact of the fuel price hike would be to raise all commodities WPI by 0.9 pps.
- 47% of this increase would be contributed by LPG, 43% by diesel and 10% by petrol. High speed diesel carries the highest weight in WPI at 2.02%, while LPG has a weight of 1.84. Petrol only has a weight of 0.89.
- WPI may eventually rise by 1.5 ppt as a result of the fuel price hike considering the dynamic effects based on the technical coefficients in the input-output matrix. Transport, food, textiles, metals, chemicals and restaurant prices could rise in the near term. It is also not possible to quantify the exact lags in transmission, but based on experiences with the past hikes, we expect about three-fourths of the indirect transmission to complete in about two months.
- We see the likelihood of inflation crossing 10% in June 2008. If that happens, it would be the first time since May 1995 that headline inflation would go into double digits. Headline inflation had hit a high of 17.1 at end-March 1995.

To say that the fuel price hike is inflationary is almost tautological. We do not, however, believe that the economy is worse off as a result of the domestic fuel price hike. The inflation would have come in anyway through a larger fiscal deficit and/or the high interest rates which a larger bond issuance would have caused later in FY2009. By raising domestic fuel prices therefore, inflation has been front-loaded and possible stagflationary pressure of interest rate shock averted.

Path of future inflation

We see inflation staying at around double-digit levels for at least the next two quarters. A possible reduction could occur in the third quarter if food prices fall with *kharif* crop arrivals. We, however, expect the inflation rate to fall significantly in 4QFY09—possibly ending the year at about 6%. This is very much in line with our earlier assessment. We continue to believe that FY2009 would be a tough year for inflation.

Oil bonds issuances may fall below Rs1.0 tn—hardly relevent to interest rates

In our view, the interest rate impact of the oil bond issuance would depend upon what the central bank does. It is possible that the oil bond issuances may have much less impact on interest rates than is currently being feared by the financial markets. This is so because these bonds do not have SLR status and as such demand and supply of gilt yields is not impacted. Just as gilt yields are rising now with inflation fears due to fuel price hike, these yields could fall steeply in 4QFY09 when inflation is expected to decline markedly.

As a result of the fuel price hike, the oil sector under-recoveries in FY2009 gets reduced to just over Rs2.0 tn from Rs2.45 tn (about US$57 bn at the current exchange rate of Rs42.7 vs. US$). However, under-recoveries of Rs419 bn remain uncovered and may necessitate further hike in domestic fuel prices unless global prices come off from current levels.

The oil bond issuance (under the assumption that other subsidy burden sharing arrangement remains the same as proposed now) would fall to Rs946 bn (US$ 22 bn) from Rs1384 bn. In our assessment, lower oil bond issuance may, at the margin, help reduce the interest rate shock facing the economy. It would also help lower secondary market yields for these bonds.

Our assessment of the impact on interest rates

- Price hike does not change the supply-demand equation for gilts as oil bonds do not have SLR status(see Exhibit 1). As such it would be gilt-yield neutral in the long run.
- However, in the short run, nominal gilt yields would rise to partly compensate for the inflation adjusted returns. We expect the gilt yields to soften after initial inflation worries subside.
- With inflation likely to touch 10%, real gilt yields are expected to be negative and demand for bonds is likely to soften as a result.
- If banks subscribe to oil bonds as non-SLR securities, price hike would in small measure lower the pressure on lending and deposit rates which may arise from bank's resources falling short in meeting expected credit demand (see Exhibit 2).

Cuts in taxes add 0.4 ppt to GFD but FRBM violation was likely even otherwise

In our assessment, FRBM fiscal rule of GFD/GDP ratio of 3.0% and budgeted target of 2.5% are likely to be breached in FY2009. The cut in fuel taxes add another 0.4 ppt to GFD which could rise to 4.8% of GDP. The Union Budget for FY2009 had already abandoned the fiscal rule for eliminating the revenue deficit. It now looks almost certain that the fiscal rule for GFD/GDP ratio would be breached as well. We believe that the FRBM Act 2003 lacks teeth, not even mandating explicit a-priori parliamentary approval for a breach. The main benefit of FRBM is that it prevents central bank participation in any primary government issuances. This too is violated in spirit by the acceptance of oil bonds by RBI.

Consequences of inadequate budgetary provisions

- Central government GFD could rise to Rs2.6 tn (or 4.3% of GDP) from the budget estimate of Rs1.3 tn (or 2.5% of GDP) (see Exhibit 3).
- We have taken a nominal GDP growth assumption of 16% in place of 13% used for the budget estimates considering the possibility of growth and inflation of 8% each.

- If off-balance sheet liabilities are considered, oil companies under-recoveries of about Rs2.02, fertilizer companies under-recoveries of Rs0.9 tn add up to nearly Rs3.0 tn or 5.5% of the GDP.
- Actual issuances of bonds (oil and fertilizer) against these are likely to be of about Rs1.4 tn.
- If budget estimates are maintained, the excess of subsidies and other items of revenue expenditure over budget estimates, along with revenue loss could be nearly another Rs1.0 tn. So, if these budget estimates are to be maintained additional liabilities of 7.4% of GDP would be needed to incurred.
- Considering the sharp reduction in total government liabilities/GDP ratio of 5.1% of GDP over last two years, we believe it is possible to absorb this fiscal shock and maintain debt sustainability unless real GDP growth falls below 7.0% over the medium to long run.

Central bank holds all the trump cards

In our assessment, the start of special market operations by the central bank may have a far more significant impact on the macro-economy than the current fuel price hike. The central bank can impart stability to interest rates and exchange rate by taking reserve loss. By acting to accept oil bonds at its window without giving such bonds an SLR status, the central bank has commendably achieved control over financial market developments while insulating the banking sector from possible weakness. It can also potentially save the economy from possible interest rate shock and run on its currency.

The end result would of course depend on the volume of bonds accepted at its window and foreign exchange released against its reserves. However, potentially, its balance sheet over the years has become very strong to absorb most of the oil bonds issued at a small forex reserve loss. It has also ensured that the liquidity in the system does not dry up as a result of its operations and has further policy options if it unexpectedly does so. RBI could unwind MSS to provide liquidity if needed. MSS outstanding are at Rs1.75 tn (US$41 bn). We also see the possibility of SLR reduction to 23% from 25% during FY2009.

Other inferences from our calculations

- Potential maximum reserve loss would have been about US$27 bn, which as a result of fuel price hike and consequent lower bond issuance would get reduced to about US$17 bn. We do not see any liquidity crunch arising as a result (see Exhibit 4).
- Losing forex reserves of about US$17 bn is not an issue with current forex reserves of US$316 bn. Even if it is accompanied by large FII outflows the reserves are enough to withstand any kind of extreme shock. In a worst-case scenario of net FII outflows of US$20 bn with an average Indian crude basket price of US$30 a barrel, the reserve loss would still be limited to around US$30 bn, though exchange rate could test Rs45 per US$ in such a case. We see exchange rate averaging about Rs42 per US$ in the base case (see also Exhibit 5).
- Balance of payment trends still suggests that there could be small reserve accretion during FY2009 in spite of the special market operations (see Exhibit 6). We do not see twin gaps arising and CAD/GDP ratio could remain contained at 2.0% well within the sustainable threshold of about 2.8%.

Exhibit 1: Oil price hike neutral to gilt yields in long run

Demand and supply of SLR securities, March fiscal-ends (Rs bn)

		2009E		
	2008E	**Scenario 1**	**Scenario 2**	**Scenario 3**
1. Demand for SLR investment (2+3+4)	**2,505**	**2,375**	**2,375**	**1,558**
2 from banks	1,812	1,504	1,504	687
3.from insurance	534	669	669	669
4. from others	159	203	203	203
5. Supply of SLR securities (6+7+8)	**2,726**	**1,975**	**2,086**	**2,086**
6. Net market borrowing of centre	1,107	990	1,188	1,188
7. State government issuances	562	545	698	698
8. MSS	1,057	440	200	200
9. Excess demand (1-5)	**(221)**	**400**	**289**	**(528)**
10. Oil bond issuances	381	..	1,384	946
Memo items				
NDTL	34,813	40,827	40,827	40,827
SLR ratio (% of NDTL)	25	25	25	23

Note:

(1) Scenario 1: Broadly in line with RBI's Annual policy monetary projections

(2) Scenario 2: With overshooting of centre and state market borrowing

(3) Scenario 3: With an SLR cut to 23% from 25%

Source: Kotak Institutional Equities.

Exhibit 2: Lower oil bond issuuance may marginally reduce pressure on interest

Sources and uses of bank funds, March fiscal year-ends (Rs bn)

		2009E			
	2008	**Scenario 1**	**Scenario 2**	**Scenario 3**	**Scenario 4**
1. Total usable sources (2 to 4)	**6139**	**5875**	**5875**	**5875**	**5875**
2. Deposits	5,802	5,500	5,500	5,500	5,500
3. Call/term funding	200	223	223	223	223
4. Overseas foreign currency borrowings	136	152	152	152	152
5. Capital	95	118	118	118	118
6. Reserves	573	417	417	417	417
7. Uses (net of credit) (8 to11)	**2,676**	**2,538**	**1,721**	**1,998**	**1,910**
8. Investment in Govt. securities	1,812	1,504	687	687	687
9. Non-SLR investments	281	284	284	561	474
10. Net foreign assets	(186)	(110)	(110)	(110)	(110)
11. Balances with RBI	769	859	859	859	859
12. Sources-uses (net of credit) (1-7)	**3463**	**3337**	**4154**	**3877**	**3965**
13. Credit offtake/demand	4,173	4,608	4,608	4,608	4,608
14. Credit gap (13-12)	**710**	**1271**	**454**	**731**	**644**
Memo items					
NDTL	34,813	40,827	40,827	40,827	40,827
SLR ratio (% of NDTL)	25	25	23	23	23
Total oil bonds issuance	381	..	1,384	1,384	946

Note:

(1) Scenario 1: Broadly in line with RBI's Annual policy monetary projections

(2) Scenario 2: SLR cut to 23% from 25%.

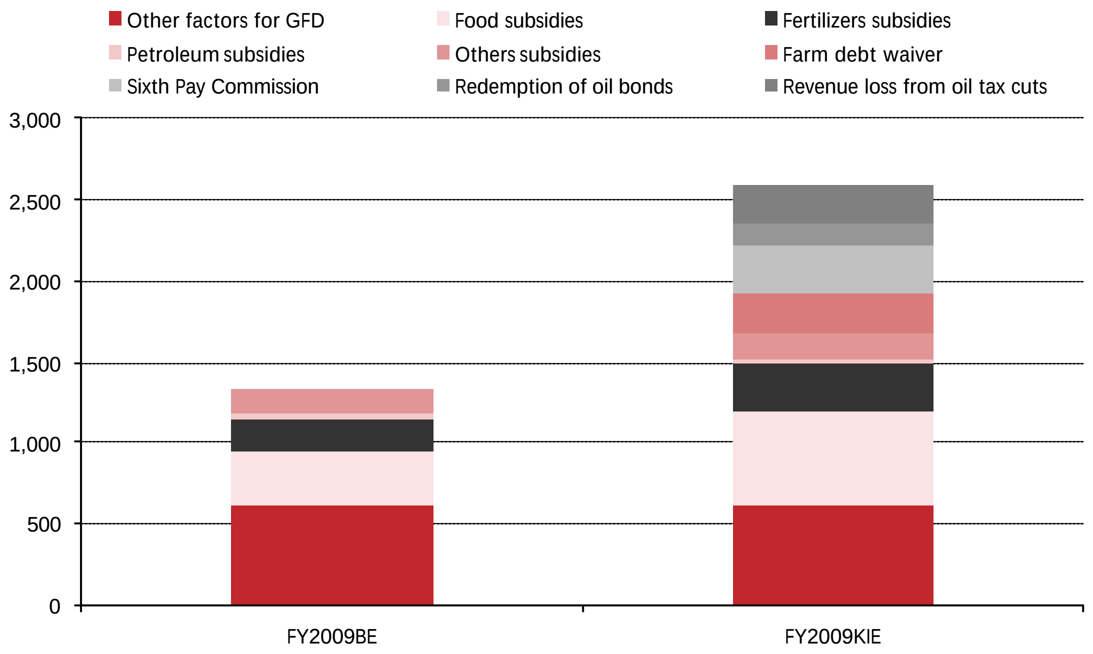
(3) Scenario 3: Banks subscribing to 20% of the issuance of oil bonds in FY2009E withoutfuel price hike.

(4) Scenario 3: Banks subscribing to 20% of the issuance of oil bonds in FY2009E with fuel price hike.

Source: Kotak Institutional Equities.

Exhibit 3: Gross fiscal deficit set to breach fiscal rule

Main contributions to GFD (in Rs bn)



Source: Government of India, Kotak Institutional Equities

Exhibit 4: RBI holds the key; likely to flexibly maintain enough liquidity

Liquidity projections, March fiscal-ends (Rs bn)

		2009E			
	2008E	Scenario 1	Scenario 2	Scenario 3	Scenario 4
1 Autonomus accretion to liquidity (2-3+4+5)	**3,656**	**1,502**	**338**	**1,479**	**753**
2 RBI's market net foreign currency purchases	3,269	820	(344)	798	72
in USD	82	19	(8)	19	2
3 Flow of surplus cash balances of government with RBI	467	(258)	(258)	(258)	(258)
4 Currency	848	416	416	416	416
5 Others	5	7	7	7	7
6 Absorption of liquidity through policy (7+8+9+10)	**1,215**	**849**	**(315)**	**849**	**123**
7 Net LAF repos	(501)	(200)	(200)	(200)	(200)
8 Market Stabilization Scheme	1,054	200	200	200	200
9 OMO (net outright sales)	(107)	(10)	(1,174)	(10)	(736)
10 First round impact of CRR change	769	859	859	859	859
11 Net increase in liquidity (1-6)	**2,440**	**653**	**653**	**630**	**630**
12 Total oil bonds issuance	353	1,384	1,384	946	946
13 Market absorption of oil bonds	165	220	220	220	220
14 Potential RBI absorption		1,164	1,164	726	726
15 Potential maximum FX reserve loss of oil bonds (in US$bn)		27	27	17	17
Memo items					
CRR at end-March	7.50	8.50	8.50	8.50	8.50
Average exchange rate (Rs/US$)		42.5	42.5	42.0	42.0

Note:
(1) Scenario 1: Without oil price hike & without RBI absorption of oil bonds
(2) Scenario 2: Without oil price hike & with RBI absorption of oil bonds
(3) Scenario 3: With oil price hike & without RBI absorption of oil bonds
(4) Scenario 4: With oil price hike & with RBI absorption of oil bonds

Source: Kotak Institutional Equities estimates.

Exhibit 5: Rupee likely to remain stable at current levels, may appreciate towrads year end

Rupee-dollar and USD/Euro exchange rates; appreciation/depreciation (%)

	2007	2008	2009E	2010E
Average Rate				
INR/USD	45.25	40.26	42.00	41.50
USD/Euro	1.28	1.42	1.60	1.62
Average depreciation (+)/appreciation (-)				
INR/USD	2.2	(12.4)	4.1	(1.2)
USD/Euro	2.2	9.9	11.3	1.2
End-period Rate				
INR/USD	43.47	40.11	41.50	41.00
USD/Euro	1.34	1.58	1.62	1.65
End-period depreciation (+)/appreciation (-)				
INR/USD	(2.7)	(8.4)	3.3	(1.2)
USD/Euro	2.2	15.2	2.5	1.8

Source: Bloomberg, Kotak Institutional Equities estimates

Exhibit 6: India's BOP sustainable to various stress scenario; CAD/GDP ratio at 2.0% in FY2009E may be a positive surprise

India's balance of payments (US$bn), March fiscal year-ends, 2007-2009E

			FY2009E			
	FY2007	FY2008E	Base	Optimistic	FII neutral	worst case
Current account	**(9.8)**	**(17.5)**	**(26.5)**	**(18.3)**	**(33.1)**	**(44.4)**
GDP	918	1,167	1,299	1,311	1,267	1,218
% of GDP	(1.1)	(1.5)	(2.0)	(1.4)	(2.6)	(3.6)
Trade balance	(63.2)	(86.8)	(115.5)	(108.1)	(123.6)	(128.3)
% of GDP	(6.9)	(7.5)	(8.9)	(8.2)	(9.8)	(10.5)
- Exports	128.1	155.5	190.1	196.5	190.1	181.7
- Imports	191.3	242.3	305.6	304.6	313.7	310.0
o/w Oil imports	58.4	77.0	106.1	96.2	114.2	120.1
o/w: non-oil	132.9	165.3	199.5	208.4	199.5	189.9
Invisibles (net)	53.4	69.3	89.0	89.8	90.5	83.9
- Services	31.8	37.2	44.9	46.0	44.9	40.9
of which: Software	29.0	35.1	42.9	43.5	42.9	39.0
- transfers	28.2	36.9	46.1	44.5	46.1	45.0
- other invisibles	(6.6)	(4.8)	(2.0)	1.8	(0.5)	(0.1)
Capital account	**45.8**	**96.2**	**52.2**	**75.1**	**39.5**	**5.8**
Foreign investment	15.5	44.6	20.8	31.5	10.5	(13.0)
- FDI	8.5	11.7	9.8	14.5	7.0	5.0
- FII	3.3	22.7	7.0	11.0	0.0	(20.0)
- ADRs/GDRs	3.8	10.2	4.0	6.0	3.5	2.0
Banking capital	1.9	8.7	5.7	7.3	4.8	5.5
- NRI deposits	4.3	(1.2)	0.9	0.0	0.9	3.4
Short-term credit	6.6	12.8	6.5	8.5	6.5	3.5
ECBs	16.2	19.1	11.5	18.0	10.0	4.0
Other capital account items	5.6	11.0	7.7	9.8	7.7	5.8
E&O	1.2	3.7	0.0	0.0	0.0	0.0
Overall balance	**37.2**	**82.4**	**25.7**	**56.8**	**6.4**	**(38.6)**
***memo:* RBI's net forex purchases**	**27.9**	**62.0**	**19.3**	**42.6**	**4.8**	**(28.9)**
Assumptions						
Global oil price (Indian basket) (US$/bbl)			110.0	100.0	120.0	130.0
Average exchange rate (Rs/US$)			42.0	41.2	43.0	45.0

Source: RBI, Kotak Institutional Equities estimtes.

Banking

Sector coverage view	Attractive

Company	Rating	Price, Rs 4-Jun	Target
SBI	ADD	1,331	1,800
HDFC	ADD	2,403	2,700
HDFC Bank	BUY	1,215	1,500
ICICI Bank	ADD	758	933
Corp Bk	ADD	320	375
BoB	ADD	241	335
PNB	BUY	466	650
OBC	ADD	167	210
Canara Bk	SELL	201	200
LIC Housing	REDUCE	325	330
Axis Bank	REDUCE	737	850
IOB	REDUCE	113	145
Shriram Transp	REDUCE	330	330
SREI	BUY	138	200
MMFSL	REDUCE	272	230
Andhra	REDUCE	72	81
IDFC	ADD	134	170
PFC	REDUCE	127	150
Centurion Bank	REDUCE	41	45
Federal Bank	BUY	210	310
J&K Bank	ADD	633	750
India Infoline	ADD	677	1,225
Indian Bank	ADD	115	150
Union Bank	BUY	127	210
Central Bank o	SELL	76	85

Reducing target prices, factoring in higher macro risk to earnings and valuations, RBI guidelines compound our concerns

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- **RBI's draft guidelines on higher capital adequacy ratio (CAR) for non-deposit-accepting NBFCs (NBFC-ND) will impact growth potential for some companies. Though both IDFC and PFC, the NBFC-NDs under our coverage, are currently well capitalized to meet new norms**
- **Subdued by the macro-environment, we are not aggressive buyers of stocks despite significant stock corrections; we are revising downwards our price targets for most assuming higher cost of equity**
- **We are, however, upgrading our ratings on IDFC and HDFC given the sharp corrections in stock prices. We prefer Srei (BUY, TP Rs200), HDFC (ADD, TP Rs2700) and IDFC (ADD, TP Rs170) in the sector.**

We expect the macro-environment for NBFCs to remain challenging over the next 12-18 months given (1) moderation in GDP growth, which could impact credit offtake, (2) inflationary pressures, leading to higher interest rates, (3) likely slippage in asset quality and (4) lower income from capital market activities. All of these could lead to pressure on earnings for NBFCs, impacting their performance. Additionally, the RBI's draft guidelines, if implemented (proposes higher CAR for NBFC-NDs 15% from April 2009 vs 10% currently), will lead to pressure on growth and RoEs in the long term. NBFC-NDs under our coverage, IDFC and PFC have recently raised equity and are well-capatililised to meet the higher CAR for now. However, the long-term growth prospects of Srei's construction equipment finance business (JV with BNP) will likely be affected on account of these regulations even as the parent company is a deposit taking NBFC and is outside the purview of these norms. Given the significant risk to earnings from the macro environment, we are increasing our cost of equity assumption by 0.5-1.2% across most NBFCs. Within this space, we like Srei (BUY), HDFC (ADD) and IDFC (ADD). Most NBFCs have underperformed the market over the past two quarters and we continue to retain a cautious view on these stocks. Our REDUCE recommendation for other stocks remain—specifically for LIC Housing Finance, Mahindra Finance, Shriram Transport Finance and Power Finance Corp..

Upgrade IDFC to ADD. RBI's revised draft guidelines require NBFC-NDs to maintain overall CAR of 15% from April 2009 and 12% with immediate effect as against 10% applicable earlier. IDFC is well placed with capital adequacy ratio of about 22% in March 2008. Post discussion with rating agencies, IDFC proposes to maintain maximum debt-equity ratio of about 7X and minimum overall CAR of about 15%. Note that the company has recently purchased Standard Chartered Mutual Fund for Rs8 bn—currently not factored in our estimates. Since the investments will likely be a set-off from its networth for calculation of Tier I capital, its CAR will likely fall below 15% over the medium term. We will need to reduce our growth estimates post 2010 which would erode its fair value by about Rs10/share. The stock has corrected significantly form its peak levels, and now trades at 17X PER and 2.5X PBR (standalone) FY2009E and we are upgrading the stock to ADD from REDUCE. Given the concerns regarding the banking sector, we believe companies with stable margins, clean balance sheet and higher RoE will likely trade at a premium in this market.

Upgrade HDFC to ADD. HDFC has corrected by about 15% over the past few trading sessions. Despite rich valuations (7.4X PBR [core] FY2009E), stock will likely outperform its banking peers given its strong operating performance (22% CAGR in operating income between FY2008 and FY2010E, RoEs above 20%), lower risk as compared to banks and appreciation in fair value of subsidiaries. We are retaining our price target of Rs2,700, upgrade recommendation to ADD from REDUCE.

Forex risk to PFC's earnings, retain REDUCE. Power Finance Corporation (PFC) had Tier I CAR of 19% in March 2008. The ratio will likely be further boosted by about 2% if the deferred tax liability is converted to networth. We find PFC comfortably placed to support its growth till FY2012E. However, the company has large forex exposure (about US$500 mn) and its near-term earnings can be significantly impacted due to volatility on this account. We are therefore not upgrading this stock, despite the sharp stock price correction.

Retain BUY on SREI, lower price target. Srei's equipment finance business has been transferred to its JV with BNP. While the parent company is a deposit-accepting NBFC, the subsidiary is NBFC-ND and will likely have to maintain 15% CAR. In case the draft guidelines are finalized, we will need to reduce our disbursements growth estimates from FY2010E onwards for the JV; this will reduce our fair value estimate by Rs10/ share. We are removing the premium to fair value (Rs 20) in our target price and raising cost of equity assumption (as discussed above); our revised price target stands at Rs200 (Rs240 earlier), we retain our BUY recommendation on the stock.

We are raising cost of equity for most of the NBFCs under coverage

	New rating	Old rating	New target price	Old target price	Market price	Upside	New cost of equity	Previous cost of equity
Stock			(Rs)	(Rs)	(Rs)	(%)	(%)	(%)
HDFC	ADD	REDUCE	2,700	2,700	2,402	12	12.0	12.0
IDFC	ADD	REDUCE	170	170	133	28	12.5	12.5
Power Finance Corp.	REDUCE	REDUCE	155	165	127	22	13.0	12.5
Shriram Transport Finance	REDUCE	REDUCE	330	355	330	-	14.0	13.5
LIC Housing Finance	REDUCE	REDUCE	330	350	325	2	14.0	13.5
Mahindra Finance	REDUCE	REDUCE	235	290	272	(14)	14.0	12.8
Srei Infrastructure Finance	BUY	BUY	200	240	138	45	13.5	13.0

Source: Kotak Institutional Equities.

Automobiles

Sector coverage view	Attractive

		Price, Rs	
Company	**Rating**	**4-Jun**	**Target**
Hero Honda	REDUCE	790	710
Tata Motors	SELL	541	525
Maruti Suzuki	BUY	747	1,000
Mah & Mah	ADD	568	720

Fuel price hike to have maximum impact on CV ownership costs—passenger car ownership costs to increase 2.4% versus 6.1% for CVs

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- **2-wheeler monthly ownership costs to increase 3% (Rs63/month)**
- **Passenger car ownership costs to increase by 2.4% or Rs260/month**
- **CV monthly ownership costs to be hit the most—6.1% or Rs6,429/month**
- **We estimate freight operators would have to increase freight rates by 6.5% to counter the impact of rise in diesel prices by Rs3/litre**
- **We do not expect any material impact on 2-W, passenger cars and CV growth**

Hike in fuel prices to have more impact on monthly ownership costs of CVs than cars, though not enough to effect growth estimates.

The hike in diesel price by Rs2/litre and petrol price by Rs5/litre will likely hit the monthly ownership costs of Commercial Vehicles (CVs) more than the passenger cars. The hike will result in increase in 2-wheeler monthly ownership costs by 3% or Rs63/ month, passenger cars by 2.4% or Rs260/month and CVs by Rs6,429/month or Rs6.1%. We believe that this would not have any material impact on demand for 2-Ws and passenger cars as the absolute increase in ownership costs is not too large. Moreover, such a small increase in ownership costs could be offset by reduced usage rather than a reduction in demand for vehicles. We believe that passenger car sales would not be materially affected. We have not made any changes to our volume growth estimates for Maruti (we estimate a 12.6% domestic volume growth for FY2009E) and continue to be positive on Maruti.

Freight operators to likely absorb fuel price hike by raising freight rates—no material impact on CV growth

We estimate that freight operators would have to increase freight rates by 6.5% to counter the effect of the hike in diesel prices. We believe that freight operators would be able to raise freight rates to the extent of 4-6%—historical evidence suggests that they have been able to absorb fuel price hikes by increase freight rates. Hence, their profitability would not be impacted materially. Consequently, this would not have an impact on our Diesel-Adjusted-Freight-Index and we believe that the CV cycle would continue to be positive. Our lead indicators have been suggesting a revival of CV volumes and we believe that demand for CVs should be strong going forward—CV volumes have been growing since Feb '08. Besides, we do not see any signs of over-supply of CVs in the system. We expect the trend to continue. We believe that CV cycle should be positive in FY2009 and the industry should witness a robust growth in M&HCVs as well as LCVs.

Impact of increase in petrol price on 2-wheelers

	Current	Increase in petrol price by Rs 5/litre	Increase in petrol price by Rs 10/llitre
Average on-road price of 2W inclusive of taxes (Rs)	40,000	40,000	40,000
% financing	90	90	90
Amount of loan (Rs)	36,000	36,000	36,000
Interest rate (%)	**14.0**	**14.0**	**14.0**
Tenure (years)	3	3	3
EMI (Rs)	1,230	1,230	1,230
Usage per day (km)	25	25	25
Mileage (km per litre)	50	50	50
Price of petrol (Rs per litre)	**50.5**	**55.5**	**60.5**
Fuel costs (Rs per month)	631	694	756
Annual maintenance costs (Rs)	2,500	2,500	2,500
Monthly maintenance costs (Rs)	208	208	208
Ownership cost (Rs per month)	**2,070**	**2,132**	**2,195**
% increase in 2W ownership cost		**3.0**	**6.0**

Source: Kotak Institutional Equities estimates.

Impact of increase in petrol price on passenger cars

	Current	Increase in petrol price by Rs 5/litre	Increase in petrol price by Rs 10/llitre
Average on-road price of car inclusive of taxes (Rs)	250,000	250,000	250,000
% financing	90	90	90
Amount of loan (Rs)	225,000	225,000	225,000
Interest rate (%)	**11.0**	**11.0**	**11.0**
Tenure (years)	3	3	3
EMI (Rs)	7,366	7,366	7,366
Usage per day (km)	25	25	25
Mileage (km per litre)	12	12	12
Price of petrol (Rs per litre)	**50.5**	**55.5**	**60.5**
Fuel costs (Rs per month)	2,630	2,891	3,151
Annual maintenance costs (Rs)	10,000	10,000	10,000
Monthly maintenance costs (Rs)	833	833	833
Ownership cost (Rs per month)	**10,830**	**11,090**	**11,351**
% increase in car ownership cost		**2.4**	**4.8**

Source: Kotak Institutional Equities estimates.

Impact of increase in diesel price of commercial vehicles

	Current	Increase in petrol price by Rs 5/litre	Increase in petrol price by Rs 10/llitre
Average on-road price of vehicle inclusive of taxes (Rs)	1,000,000	1,000,000	1,000,000
% financing	90	90	90
Amount of loan (Rs)	900,000	900,000	900,000
Interest rate (%)	**11.0**	**11.0**	**11.0**
Tenor (years)	3	3	3
EMI (Rs)	29,465	29,465	29,465
Usage per day (km)	300	300	300
Mileage (km per litre)	4	4	4
Price of petrol (Rs per litre)	**34.7**	**37.7**	**39.7**
Fuel costs (Rs per month)	74,357	80,786	85,071
Annual maintenance costs (Rs)	20,000	20,000	20,000
Monthly maintenance costs (Rs)	1,667	1,667	1,667
Ownership cost (Rs per month)	**105,489**	**111,917**	**116,203**
% increase in CV ownership cost		**6.1**	**10.2**

Source: Kotak Institutional Equities estimates.

Freight operators need to increase freight rates by 6.5% to maintain profitability

Increase in diesel price (Rs/litre)	2.00	**3.00**	4.00	5.00
Increase in freight rate (%)	4.3	**6.5**	8.6	10.8

Source: Kotak Institutional Equities estimates.

Industrials

Sector coverage view	Neutral

		Price, Rs	
Company	**Rating**	**4-Jun**	**Target**
BHEL	ADD	1,475	1,750
BGR	ADD	296	390
L&T	BUY	2,756	3,600
BEL	ADD	1,133	1,475
ABB	REDUCE	970	1,125
Dredging	REDUCE	568	775
Suzlon	ADD	247	350
AIA Engineerin	REDUCE	72	1,750
Siemens	REDUCE	515	600

Early kick-start to L&T's power equipment business with its lowest bid for Krishnapatnam project; marks onset of competition for BHEL

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- **Early kick-start to L&T's power equipment business with its lowest bid for Krishnapatnam project; marks the onset of competition for BHEL**
- **Krishnapatnam project had been under the bidding stage for a long time; earlier tendering process was cancelled as BHEL was the sole bidder**
- **Difference in pricing as suggested by news reports seems surprising; L&T's low bid however indicates its aggressive plans**
- **Revise target price of BHEL to Rs1,750 (from Rs1,875 earlier); upgrade to ADD (from REDUCE earlier)**
- **Maintain target price of Rs3,600 for L&T, reiterate BUY rating**

Media reports suggest that L&T has outbid BHEL for supplying the main power equipment for the 2X800 MW Krishnapatnam project. We believe that this will be an earlier-than-expected start for L&T's power equipment manufacturing business as it had been expecting negotiated orders from NTPC to kick-start this business. The project award will mark the actual onset of domestic competition for BHEL and may alter the dynamics of power equipment pricing in the super-critical category. We are surprised by L&T's low bid of about over Rs15 bn compared to BHEL's bid of Rs20 bn. L&T's low bid suggests that it is very keen to kick-start its power equipment manufacturing business and is eager to demonstrate the same as negotiated orders for NTPC are likely in the offing. We revise our target price for BHEL to Rs1,750 (from Rs1,875 earlier). We upgrade our rating to ADD (from REDUCE earlier). We maintain our target price of Rs3,600 for L&T and our BUY rating.

Early kick-start to L&T’s power equipment business with its lowest bid for Krishnapatnam project; marks onset of competition for BHEL

Media reports suggest that L&T has outbid BHEL for supplying the main power equipment for the 2X800 MW Krishnapatnam project in Andhra Pradesh. We believe that this will be an earlier-than-expected start for L&T’s power equipment manufacturing business as it had been expecting negotiated orders from NTPC to kick-start this business. The project award will mark the actual onset of domestic competition for BHEL. We highlight that this project was re-bid after BHEL had emerged as the sole bidder in the last round of bidding and hence BHEL was widely expected to win this project. We highlight that we ascribe a value of about Rs50 per share of L&T for the power equipment manufacturing business (Exhibit 1).

Krishnapatnam project had been under the bidding stage for a long time; earlier tendering process was cancelled as BHEL was the sole bidder

The Rs80 bn Krishnapatnam project had been delayed by more than a year (earlier commissioning plans of September 2011 and March 2012 for the two units respectively). In the earlier round of bidding for EPC contracts, tenders were cancelled in December by Andhra Pradesh Power Development Corp (APPDC–an equal JV of APGENCO and IL&FS) after only BHEL responded and APPDC feared that it would end-up overpaying BHEL (the project had likely generated interest from Alstom and Toshiba at the RFQ stage, as suggested by news reports). APPDC then divided the project into three packages of boilers, turbines and BoP to elicit a wider response. In this round of bidding also, involving manufacturing and commissioning of two steam generators and boilers, BHEL and L&T were the only bidders.

Difference in pricing as suggested by news reports seems surprising; however, L&T's low bid indicates its aggressive plans

We are surprised by L&T's low bid of about over Rs15 bn compared to BHEL's bid of Rs20 bn. It seems likely that the difference between the bids as reported in the media is exaggerated. In any case, it is likely that L&T has bid aggressively for strategic reasons and may not make profits from this particular project given that (1) L&T's bid is significantly below BHEL's bid and (2) a large proportion of the equipment will likely be imported from the JV partner Mitsubishi Heavy Industries (though L&T's facility is expected to start production from mid-CY2009E, we believe that it may not be in a position to manufacture a large proportion of the total equipment requirement (at least the critical components) for this project).

This win would be a shot in the arm for NTPC's negotiated orders too

L&T's low bid suggests that it is very keen to kick-start its power equipment manufacturing business and is eager to demonstrate the same as negotiated orders for NTPC are likely in the offing. The Power Ministry appears to have decided that negotiated orders for seven of NTPC's projects would be awarded this year, with four orders going to the L1 domestic bidder and three orders to the L2 domestic bidder (at L1's price). The possible projects for which such negotiated orders are likely to be put are 4X800 MW Lara project (Chattisgarh), 2X800 MW Darlipala project (Orissa) and 2X800 MW Barh Extension (Bihar). L&T's management had stated that it has given an indigenization schedule to government which is better than that of BHEL.

Revise target price of BHEL to Rs1,750 (from Rs1,875 earlier); upgrade to ADD (from REDUCE earlier)

We revise our target price for BHEL to Rs1,750 (from Rs1,875 earlier). Our target price now implies a P/E multiple of 24.6X and 19.6X our FY2009E and FY2010E EPS estimates, respectively. BHEL is currently trading at 20.7X and 16.5X FY2009E and FY2010E EPS estimates, respectively.

We upgrade our rating to ADD (from REDUCE earlier) based on recent sharp correction in the stock and 19% upside to our target price. Stock has underperformed the market by 18% since we changed our rating to REDUCE from ADD on April 15, 2008. We also highlight that the stock has underperformed the market by 22.5%, 23.5% and 9.8% over the past six, three months and one month, respectively. Key catalysts for the stock include (1) negotiated orders for 800MW supercritical units from NTPC, (2) visibility on execution of projects in JVs like that with TNEB for supercritical projects (including projects like Koradi, Maharashtra and OBRA, UP) and (3) strong execution resulting in robust near-term earnings growth.

Key risks include (1) commodity price pressures leading to lower margins, (2) possible deterioration in competitive position with foreign vendors as well as domestic equipment manufacturers winning significant orders in India particularly from the private sector, (3) potential slips ups in the XIth and XIIth plan execution that would reduce market opportunity and (4) larger role that private sector is likely to have in power generation capacity addition in future as compared to the past.

Maintain target price of Rs3,600 for L&T, reiterate BUY rating

We maintain our target price of Rs3,600 for L&T and our BUY rating (Exhibit 3). We believe L&T is the best play on India's growth story led by (1) strong momentum in infrastructure and industrial investments across sectors and L&T's positioning in terms of breadth of skills and execution depth, (2) L&T's ability to build sizeable businesses in related segments of engineering such as power equipment manufacturing, shipbuilding, defense and hydro-power construction, further diversifying its revenue stream, (3) infrastructure development upside by equity participation in projects through L&T IDPL and (4) Potential for increasing international presence, particularly in Middle-East.

Key risks emerge from (1) execution challenges in a tight demand-supply environment for technical and managerial skills, (2) potential hiccups in ramp up of several new business segments such as defense, power equipment manufacturing and shipbuilding, (3) slowdown in infrastructural and industrial capital expenditure with increase in interest rates or slower economic growth and (4) possible margin pressures led by commodity price increases.

Exhibit 1. We attribute a value of Rs50 to L&T's 51% share in the power equipment manufacturing JVs with Mitsubishi Heavy Industries
Modelling of L&T's power equipment JVs with MHI, March fiscal year-ends FY2009E-2019E, (Rs mn)

	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E
Modelling Assumptions											
Capacity			3500	3500	3500	4000	4500	5000	5000	6000	6000
Capacity utilisation (%)			30	45	55	65	75	75	75	75	75
MW equipment sold			**1050**	**1575**	**1925**	**2600**	**3375**	**3750**	**3750**	**4500**	**4500**
Realisation per MW (Rs mn)			22.5	24	25	26	27	29	30	32	33
Growth in realisation per MW (%)			0	5	5	5	5	5	5	5	5
Revenues (Rs mn)			**23,625**	**37,209**	**47,752**	**67,721**	**92,303**	**107,686**	**113,071**	**142,469**	**149,592**
EBITDA margin (%)			5	7.5	12	14	14	14	14	14	14
EBITDA (Rs mn)			**1,181**	**2,791**	**5,730**	**9,481**	**12,922**	**15,076**	**15,830**	**19,946**	**20,943**
Balance sheet model											
Share holder's Funds	**3,000**	**6,000**	**5,566**	**4,902**	**6,148**	**9,601**	**15,115**	**21,921**	**29,345**	**39,346**	**50,047**
Capital	3,000	6,000	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500
Reserves and surplus			(1,934)	(2,598)	(1,352)	2,101	7,615	14,421	21,845	31,846	42,547
Loan Funds	5,000	10,000	16,000	18,000	20,000	21,500	21,500	20,000	15,000	12,500	7,500
Total	**8,000**	**16,000**	**21,566**	**22,902**	**26,148**	**31,101**	**36,615**	**41,921**	**44,345**	**51,846**	**57,547**
Net block	8,000	16,000	15,589	15,603	15,886	16,750	18,303	20,126	21,803	24,200	26,403
Cash & bank balances			2,433	1,717	3,099	4,192	4,466	5,642	5,581	6,276	8,705
Net current assets			3,544	5,581	7,163	10,158	13,845	16,153	16,961	21,370	22,439
Total	**8,000**	**16,000**	**21,566**	**22,902**	**26,148**	**31,101**	**36,615**	**41,921**	**44,345**	**51,846**	**57,547**
DCF valuation of power equipment JV											
EBITDA			1,181	2,791	5,730	9,481	12,922	15,076	15,830	19,946	20,943
Tax payment					(656)	(1,819)	(2,904)	(3,585)	(3,910)	(5,268)	(5,636)
EBITDA*(1 - tax)			1,181	2,791	5,074	7,662	10,018	11,491	11,920	14,678	15,307
Capex	(8,000)	(8,000)	(945)	(1,488)	(1,910)	(2,709)	(3,692)	(4,307)	(4,523)	(5,699)	(5,984)
Working capital			(3,544)	(2,038)	(1,581)	(2,995)	(3,687)	(2,308)	(808)	(4,410)	(1,069)
Free cash flow for the firm	(8,000)	(8,000)	(3,308)	(735)	1,582	1,958	2,639	4,876	6,589	4,569	8,254
No of years	0	1	2	3	4	5	6	7	8	9	10
Discount factor	1.0	0.9	0.8	0.7	0.6	0.6	0.5	0.4	0.4	0.3	0.3
Sum of cash flows	(6,034)										
Terminal value	35,586										
Total value	29,553										
Per share valuation (Rs)	**98.6**										
Discount rate (%)	12.5										
Terminal growth rate (%)	5.0										

Source: Kotak Institutional equities estimates

Exhibit 2: Our DCF based valuation results in a target price of Rs1,750/share
DCF valuation for BHEL, March fiscal year ends, 2009E-2019E (Rs mn)

Year to March	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E
Revenue	**247,373**	**318,230**	**365,145**	**417,012**	**410,019**	**489,341**	**591,453**	**712,600**	**787,300**	**866,031**	**952,634**
Growth (%)	*27.7*	*28.6*	*14.7*	*14.2*	*(1.7)*	*19.3*	*20.9*	*20.5*	*10.5*	*10.0*	*10.0*
EBIT margin	*19.7*	*16.8*	*20.0*	*20.0*	*18.5*	*18.5*	*18.5*	*18.5*	*18.0*	*18.0*	*18.0*
EBIT*(1-tax rate)	**32,141**	**35,245**	**48,147**	**54,995**	**50,063**	**59,749**	**72,216**	**87,009**	**93,531**	**102,884**	**113,173**
Depreciation	3,546	4,430	5,213	5,792	6,008	5,761	5,865	6,277	6,888	6,725	6,649
Change in working capital	(8,694)	(12,707)	(14,381)	(5,824)	839	(9,519)	(12,253)	(14,538)	(8,964)	(9,448)	(10,392)
Capital expenditure	(13,000)	(13,000)	(7,000)	(7,000)	(4,626)	(6,346)	(8,169)	(9,692)	(5,976)	(6,298)	(6,928)
Free Cash Flows	**13,993**	**13,969**	**31,979**	**47,964**	**52,285**	**49,645**	**57,660**	**69,056**	**85,479**	**93,863**	**102,501**
Growth (%)	*(65.3)*	*(0.2)*	*128.9*	*50.0*	*9.0*	*(5.0)*	*16.1*	*19.8*	*23.8*	*9.8*	*9.2*
Years discounted	-	1	2	3	4	5	6	7	8	9	10
Discount factor	1.00	0.89	0.79	0.70	0.62	0.55	0.49	0.44	0.39	0.35	0.31
Discounted cash flow	**13,993**	**12,417**	**25,267**	**33,686**	**32,641**	**27,549**	**28,442**	**30,279**	**33,315**	**32,518**	**31,565**

Target price calculation	Rs mn
Sum of free cash flow	301,673
Discounted terminal value	441,907
Enterprise value	743,579
Add Investments	83
Net debt	(108,627)
Net present value-equity	852,289
Shares o/s	490
Target price /share(Rs)	**1,741**

Terminal value calculation	
Cash flow in terminal year	102,501
Growth to perpetuity (g)	***5.0%***
Capitalisation rate (WACC-g)	*7.5%*
Terminal value	1,435,013
Discount period (years)	10.0
Discount factor	0.31
Discounted terminal value	**441,907**

WACC calculation	
Risk-free rate (Rf)	*7.5%*
Beta (B)	1.00
Equity risk premium	*5.0%*
Expected market Return (Rm)	*12.5%*
Cost of Equity (Ke)	*12.5%*
Cost of Debt (Kd) (Post-tax)	*8.0%*
WACC	***12.5%***

Terminal multiples	
EV/EBIDTA	8.8
P/FCF	14.0

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 3. Sum of the Parts valuation of L&T gives a target price of Rs3,600/share
SOTP valuation of L&T

	Original invt	Mkt value	Implied val on 09 estimates (X)			L&T's stake	Value of L&T's stake	Value per share of L&T	
	(Rs mn)	(Rs mn)	P/E	P/B	EV/EBIDTA	%	(Rs mn)	(Rs)	Basis of valuation
Core company valuation			**29.9**	**6.2**	**20.8**		**840,283**	**2,879**	**FY09 based DCF**
Key subsidiaries - services	1,454	70,757					70,757	250	
L&T Finance	1,304	25,717	15.1	2.7	NA	100.0	25,717	91	Relative P/E
L&T Infotech	150	45,041	15.7	5.4	11.3	100.0	45,041	159	Relative P/E
Key subsidiaries - manufacturing	911	74,800					38,692	190	
Tractor Engineers	3	2,584	21.9	3.7	15.6	100.0	2,584	9	Relative P/E
Associate companies*	908	72,216	21.9	NA	NA	50.0	36,108	127	Relative P/E
Power equipment JVwth MHI	7,500	29,553	NA	NA	NA	51.0	15,072	53	DCF of the JV
Infrastructure SPVs	10,790	53,949				79.0	42,620	150	P/B
Other subsidiaries	9,012						18,025	64	P/B
Total subsidiaries	**13,062**						**170,094**	**654**	
UltraTech Cement	143	87,217					10,030	35	Market value
Other associate companies	279	557					557	2.0	2X investment
Integrated JVs	279	558					558	2.0	2X investment
Total associates and IJVs	**701**	**88,332**					**11,145**	**39**	
Financial investments	**16,865**	**16,865**					**16,865**	**60**	**Book value**
Grand total	**30,628**	**105,197**					**1,038,387**	**3,632**	

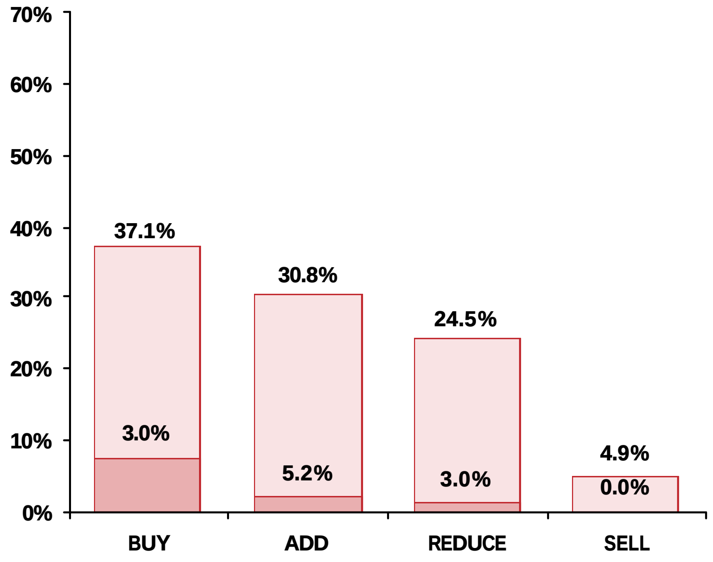
* includes L&T Komatsu, L&T Case, Audco India and EWAC Alloys

Source: Company data, Kotak Institutional Equities estimates.

"Each of the analysts named below hereby certifies that, with respect to each subject company and its securities for which the analyst is responsible in this report, (1) all of the views expressed in this report accurately reflect his or her personal views about the subject companies and securities, and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report: Sanjeev Prasad, Kawaljeet Saluja, Mridul Saggar, Tabassum Inamdar, Lokesh Garg, Amit Agarwal."

Kotak Institutional Equities Research coverage universe

Distribution of ratings/investment banking relationships



Percentage of companies covered by Kotak Institutional Equities, within the specified category.

Percentage of companies within each category for which Kotak Institutional Equities and or its affiliates has provided investment banking services within the previous 12 months.

* The above categories are defined as follows: Buy = OP; Hold = IL; Sell = U. Buy, Hold and Sell are not defined Kotak Institutional Equities ratings and should not be constructed as investment opinions. Rather, these ratings are used illustratively to comply with applicable regulations. As of 31/03/2008 Kotak Institutional Equities Investment Research had investment ratings on 143 equity securities.

Source: Kotak Institutional Equities. As of March 31, 2008

Ratings and other definitions/identifiers

New rating system

Definitions of ratings

BUY. We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.
ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.
REDUCE: We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.
SELL: We expect this stock to underperform the BSE Sensexby more than 10% over the next 12 months.

Old rating system

Definitions of ratings

OP = Outperform. We expect this stock to outperform the BSE Sensex over the next 12 months.
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.

Other definitions

Coverage view. The coverage view represents each analyst's overall fundamental outlook on the Sector. The coverage view will consist of one of the following designations: Attractive (A), Neutral (N), Cautious (C).

Other ratings/identifiers

NR = Not Rated. The investment rating and target price, if any, have been suspended temporarily. Such suspension is in compliance with applicable regulation(s) and/or Kotak Securities policies in circumstances when Kotak Securities or its affiliates is acting in an advisory capacity in a merger or strategic transaction involving this company and in certain other circumstances.
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NM = Not Meaningful. The information is not meaningful and is therefore excluded.

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