investor's eye

Index

Take Five

Scrip	Reco Date	Reco Price	CMP	Target
Aban Offshore	03-Mar-05	330	**1,218**	1,760
HLL	24-Nov-05	172	**236**	300
ICICI Bank	23-Dec-03	284	**631**	770
Orient Paper	30-Aug-05	214	**626**	675
UltraTech	10-Aug-05	384	**784**	1,000

Sharekhan Ltd
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Solectron Centum Electronics

Emerging Star

Stock Update

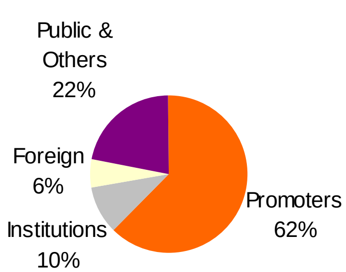
Poised to grow

Hold; CMP: Rs174

Company details

Price target:	Rs250
Market cap:	Rs258 cr
52 week high/low:	Rs340/127
NSE volume: (No of shares)	26,252
BSE code:	517544
NSE code:	SOLECTCENT
Sharekhan code:	SOLECTCENT
Free float: (No of shares)	56 lakh

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	2.9	8.4	-39.7	-39.8
Relative to Sensex	-1.5	-12.6	-45.0	-58.6

We attended the annual general meeting (AGM) of Solectron Centum Electronics Ltd (SCEL) recently. The key takeaways from the AGM are given below.

Enhanced focus on the Indian operations by Solectron, US

The AGM was chaired by Perry Hayes, the chairman of SCEL and senior vice president at Solectron Corporation, US (the parent company of SCEL). The facts that the nominee of Solectron Corporation, US was for the first time attending the AGM and had specifically traveled to India for the same clearly indicate the growing importance of the Indian operations. Mr Hayes stated that India is fast emerging as an alternate low-cost manufacturing destination for Solectron Corporation, US and many other equipment manufacturers across various industries. That's because the domestic demand is quite robust in India and it is a reasonably cost-competitive location. In terms of outlook, Solectron Corporation, US expects the Indian revenues to grow at a healthy rate over the next four to five years.

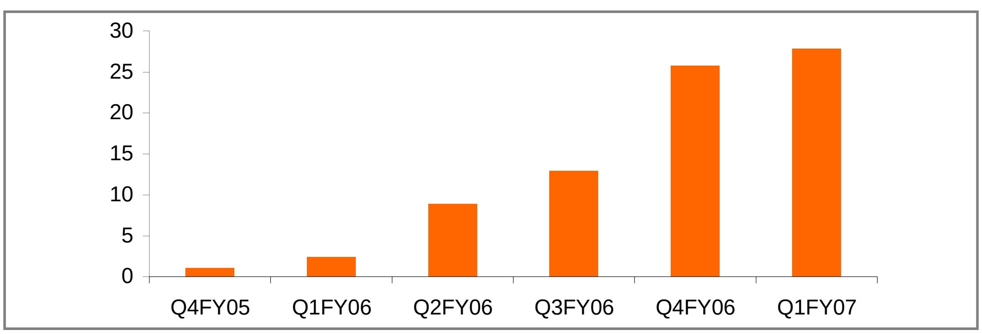
Component business to pick up

The SCEL management indicated that the revenues from the component business are expected to improve significantly in the current fiscal. The revival would be driven by the renewed demand from one of SCEL's key customers and erstwhile parent, C-MAC. In FY2005, Solectron Corporation, US divested C-MAC, resulting in subdued demand due to the transition and restructuring within C-MAC. However, the forecast for the current year is strong. Secondly, the execution of the Rs35-crore pending order from Indian Space and Research Organisation (ISRO) is also expected to aid the overall growth in the component business of SCEL.

Capacity constraints could limit the growth in its service business

The electronic manufacturing service (EMS) business has been the key growth driver in FY2006, with a ten-fold increase in its revenues in the last fiscal. The EMS business is expected to grow at a healthy rate in FY2007 also on the back of a ramp-up from the existing client base and the addition of some new large clients during the year. However, the quarterly revenue run rate is likely to remain limited at around Rs26-27 crore reported in the last two quarters (thus, limiting the sequential growth witnessed earlier) largely due to capacity constraints.

Sequential growth in EMS revenues to flatten out (Rs cr)

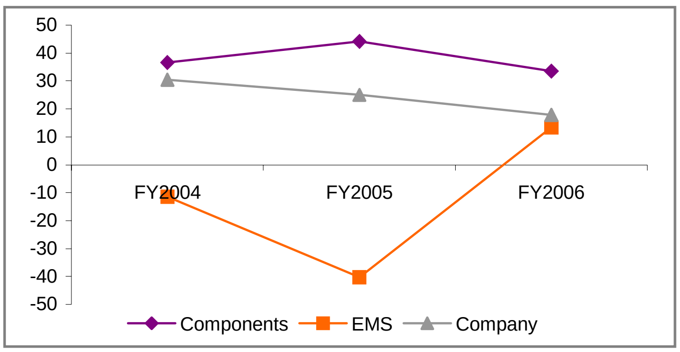


The second and third assembly lines commissioned in FY2006 are already fully utilised and SCEL does not have spare space at the existing manufacturing location. Thus, the management has chalked out a greenfield expansion plan that could be located at Chennai or Hyderabad. To fund the expansion and the increasing working capital requirement, an enabling resolution to borrow up to Rs200 crore was passed in the AGM.

Margins to trend downwards

SCEL's operating profit margin (OPM) has declined considerably over the past two years from 30.5% in FY2004 to 17.9% in FY2006. The competition-led pricing pressure in the component business and the increasing contribution from the relatively lower-margin EMS business are the two key reasons for the steep decline in the company's overall profitability.

Declining margins (%)



The management expects the declining margin trend to continue going forward. First, the proportion of the EMS revenues in the total turnover would increase further over the next couple of years. Secondly, the OPM in the EMS business itself is expected to gradually align with the benchmark of 4-6% reported by EMS companies globally. The EMS margins of SCEL stood at 13.4% in FY2006. Despite the margin pressure, the management expects the operating profit to grow at a healthy rate (in absolute terms) due to aggressive scale-up of the business.

Consolidate and build a platform for the next phase of growth

In terms of the outlook, the management intends to consolidate the EMS business (to stabilise after the exponential growth) and revive growth in the component business in the current year. Moreover, the management would focus on building infrastructure—both in terms of manufacturing capacities and manpower—in the EMS segment to usher the next phase of growth.

No dividend pay-out

On the dividend policy, the management clearly stated that it proposes to utilise the internal accruals for its expansion programme. Moreover, the company wasn't able to generate any free cash flow from the operating activity (after working capital changes) from the operations due to the highly working capital-intensive nature of the EMS business. Consequently, the company has not announced any dividend in FY2006 and is unlikely to do so in the current year also.

Valuation

To summarise, SCEL has established itself in the EMS space and has aggressive plans to scale up the operations over the next couple of years. The growth in the component business is also likely to revive in the current fiscal. Though the margins would continue to remain under pressure, the profits in the absolute terms would grow at a healthy rate due to the expected aggressive growth in its revenues.

At the current price the stock trades at 19.6x FY2007 and 17.3x FY2008 estimated earnings. We maintain our Hold recommendation on the stock with a revised price target of Rs250. The decision to upgrade the rating will depend on distinct signs of the revival of growth in the component business (like the commencement of the Rs35-crore high-margin government order and an increase in the demand for components from C-MAC).

Earnings table

Year ended Mar 31	FY05	FY06	FY07E	FY08E
Net sales (Rs cr)	42.2	83.3	136.7	167.9
Net profit (Rs cr)	12.9	9.9	13.2	15.0
Shares in issue (cr)	1.5	1.5	1.5	1.5
EPS (Rs)	8.7	6.7	8.9	10.1
% y-o-y growth	*55.0*	*-23.0*	*33.0*	*14.0*
PER (x)	20.0	26.1	19.6	17.3
Book value (Rs)	20.5	30.9	38.7	47.7
P/BV (Rs)	8.5	5.7	4.5	3.7
EV/EBIDTA (x)	17.6	14.4	7.3	5.7
Dividend yield (%)	1.0	-	-	1.0
RoCE (%)	39.3	29.7	35.0	33.6
RoNW (%)	44.5	26.1	25.6	23.5

Life insurance

Sector Update

Creating value

Insurance business continues to create value

According to the latest report released by the Insurance Regulatory and Development Authority, the first year premium collection of the life insurance companies grew by a whopping 177% year on year (yoy) from Rs6,524 crore to Rs18,096 crore for the period April-July 2006.

In the private sector, ICICI Prudential Life Insurance (IPLI) as well as Bajaj Allianz Life Insurance (BALI) continued to be the growth leaders with a 206% and a 149% year-on-year growth respectively.

We estimate the value of IPLI to be Rs66 per share of ICICI Bank and that of BALI at Rs700 per share of Bajaj Auto. We believe that as the robust growth in the sector continues on the back of the changing demographics and investment patterns of the Indian people, the insurance joint ventures of these companies would keep creating higher value for their shareholders.

Company	Parent	Holding (%)	Value per share of parent company (Rs)	As % of parent's CMP
IPLI	ICICI Bank	74.0	66.0	10.5
BALI	Bajaj Auto	74.0	700.0	25.2
Birla Sunlife	Aditya Birla Nuvo	74.0	160.0	19.6

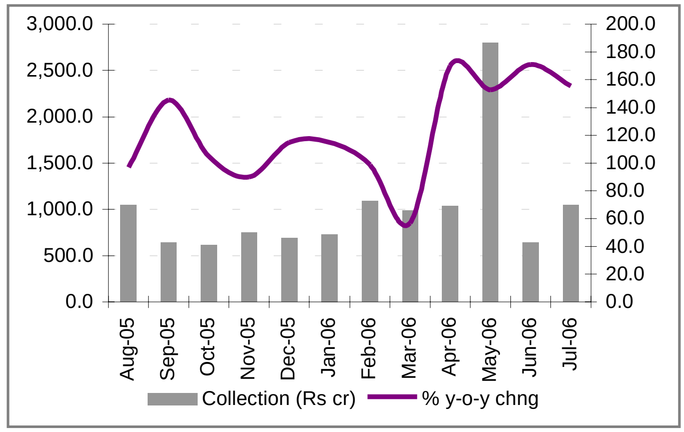
Source: Sharekhan research

Premium collections show robust growth

During July 2006, the private life insurance companies saw a growth of 161% yoy in the first premium collection to Rs4,068 crore. Public sector insurer Life Insurance Corporation's (LIC) first premium collection increased by a mammoth 182% yoy to Rs14,027 crore during the same period. The launch of a new single premium product called "Jeevan Tarang" (which is eligible for tax deductions) helped LIC to achieve this commendable growth.

In the private sector, IPLI witnessed the highest first premium collection of Rs1,157 crore, achieving a growth of 149% over the same period last year. It was followed by BALI whose first premium collection grew by 206% yoy to Rs833 crore.

Private players continue the robust show

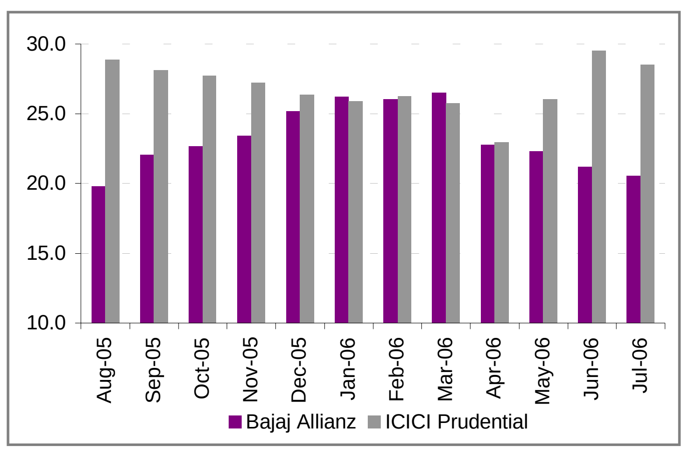


Source: IRDA, Sharekhan research

IPLI takes lead in private sector

Over the last couple of years, IPLI and BALI have contested a tough fight to maintain their market leadership amongst the private players. In the current year up to July, IPLI has maintained its market leadership with a share of 28.5% followed by BALI with a 21% market share. Both the companies recorded a significant growth in their premium collections driven by a larger number of policies and higher ticket size.

Market shares in YTD first year premium collection (%)



Source: IRDA, Sharekhan research

Sharekhan Stock Ideas

Evergreen

- HDFC Bank
- Infosys Technologies
- Reliance Industries
- Tata Consultancy Services

Apple Green

- Aditya Birla Nuvo
- Associated Cement Companies
- Bajaj Auto
- Balrampur Chini Mills
- Bank of Baroda
- Bank of India
- Bharat Bijlee
- Bharat Heavy Electricals
- Canara Bank
- Corporation Bank
- Crompton Greaves
- Elder Pharmaceuticals
- Godrej Consumer Products
- Grasim Industries
- Hindustan Lever
- Hyderabad Industries
- ICICI Bank
- Indian Hotels Company
- ITC
- Mahindra & Mahindra
- Marico Industries
- Maruti Udyog
- MRO-TEK
- Lupin
- Nicholas Piramal India
- Omax Auto
- Ranbaxy Laboratories
- Satyam Computer Services
- SKF India
- State Bank of India
- Sundaram Clayton
- Tata Motors
- Tata Tea
- Unichem Laboratories
- Wipro

Cannonball

- Allahabad Bank
- Andhra Bank
- Cipla
- Gateway Distriparks
- International Combustion (India)
- JK Cement
- Madras Cement
- Shree Cement
- Transport Corporation of India

Emerging Star

- 3i Infotech
- Aban Offshore
- Cadila Healthcare
- KSB Pumps
- Marksans Pharma
- Navneet Publications (India)
- New Delhi Television
- Orchid Chemicals & Pharmaceuticals
- ORG Informatics
- Solectron Centum Electronics
- Television Eighteen India
- Thermax
- TVS Motor Company
- UTI Bank
- Welspun Gujarat Stahl Rohren

Ugly Duckling

- Ashok Leyland
- Deepak Fertilisers & Petrochemicals Corporation
- Genus Overseas Electronics
- HCL Technologies
- ICI India
- Jaiprakash Associates
- JM Financial
- KEI Industries
- NIIT Technologies
- Punjab National Bank
- Ratnamani Metals and Tubes
- Sanghvi Movers
- Saregama India
- Selan Exploration Technology
- Subros
- Sun Pharmaceutical Industries
- Surya Pharmaceuticals
- UltraTech Cement
- Union Bank of India
- Universal Cables
- Wockhardt

Vulture's Pick

- Esab India
- Orient Paper and Industries
- WS Industries India

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