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Economy: Fed cuts 25 bps: market disappointment is an overreaction as more cuts on anvil later

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News Roundup

Corporate

* Suzuki Motor Corporation (SMC) said that it would launchtis compact car model from India next year for the export and domestic markets. (BL)

* Nokia is planning to expand its focus to offer a range of Internet-based services in India early next year. (BL)

* United Phosphorus (UPL), the country's largest crop protection company, is set to bid for Australia's largest atgriculture chemical company, Nufarm. (BS)

* US-based luxury hotel chain Orient-Express has rebuffed Tata Group's offer for an alliance saying any association with the "predominantly Indian" chain will erode the value of its premium brands. (BS)

Economic and political

* The RBI may soon tighten the norms for foreign exchange derivatives, amid several banks and companies facing losses with calls on currency movements going wrong. (BS)

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

EQUITY MARKETS

		Change, %		
India	**11-Dec**	**1-day**	**1-mo**	**3-mo**
Sensex	20,291	1.8	8.3	30.9
Nifty	6,097	2.3	8.5	35.6
Global/Regional indices				
Dow Jones	13,433	(2.1)	3.0	0.9
Nasdaq Composite	2,652	(2.4)	0.9	2.1
FTSE	6,537	(0.4)	3.7	4.1
Nikkie	15,750	(1.8)	3.6	(0.3)
Hang Seng	28,525	(2.4)	3.1	17.3
KOSPI	1,898	(1.4)	(1.3)	4.7

Value traded - India

			Moving avg, Rs bn	
	11-Dec		**1-mo**	**3-mo**
Cash (NSE+BSE)	264.0		267.9	264.9
Derivatives (NSE)	594.2		14.1	417.1
Deri. open interest	1,052.5		190.0	812.5

Forex/money market

		Change, basis points		
	11-Dec	**1-day**	**1-mo**	**3-mo**
Rs/US$	39.3	-	(0)	(108)
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	7.9	1	(4)	1

Net investment (US$mn)

	10-Dec		**MTD**	**CYTD**
FIIs	75		581	16,728
MFs	18		100	743

Top movers -3mo basis

		Change, %		
Best performers	**11-Dec**	**1-day**	**1-mo**	**3-mo**
Neyveli Lignite	254	(1.8)	30.3	176.9
Reliance Energy	1,946	(0.0)	7.0	117.6
Engineers India	919	5.0	2.5	98.7
MRF	7,464	2.0	0.3	95.0
Reliance Cap	2,422	1.2	20.3	82.0
Worst performers				
i-Flex	1,581	(1.1)	10.8	(17.9)
Container Corp	1,850	(1.5)	(2.5)	(15.0)
Glaxosmithkline	1,022	3.6	(0.2)	(10.0)
Britannia	1,451	(0.7)	(5.0)	(4.9)
Essel Propack	64	0.3	32.2	(4.7)

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Construction	
SADE.BO, Rs1083	
Rating	BUY
Sector coverage view	Attractive
Target Price (Rs)	1,385
52W High -Low (Rs)	1240 - 380
Market Cap (Rs bn)	14.2

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	4.9	8.7	13.3
Net Profit (Rs bn)	0.3	0.5	0.9
EPS (Rs)	23.7	43.9	69.5
EPS gth	*21.1*	*85.1*	*58.3*
P/E (x)	45.7	24.7	15.6
EV/EBITDA (x)	25.3	14.1	8.6
Div yield (%)	0.3	0.5	0.8

Sadbhav Engineering: New value driver on construction roadmap.

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- **Initiate with BUY; SOTP-based target price of Rs1,385**
- **Aggressive pursuit of new focus: Building up BOT assets**
- **Revenue visibility of 26 months: Expect PAT CAGR of 60% over FY2007-10E**
- **Key risks: Execution; slowdown in infrastructure investment**

Sadbhav Engineering, a company focused on the construction of roads and irrigation projects, has recently diversified into BOT road projects. We believe strong execution capabilities across segments and increasing infrastructure investments will drive order flows and earnings for the company. We value its construction business at Rs1,000/share and BOT project portfolio at Rs385/share. We expect increasing infrastructure investments to be the key factor impacting growth.

Initiate with BUY; SOTP-based target price of Rs1,385

We value Sadbhav using the SOTP methodology—valuing construction business on EV/ EBITDA and BOT projects on DCF basis. We value the construction business at Rs1,000/ share based on 7.9X FY2009E EBITDA and BOT projects at Rs385/share. We expect order book addition and efficient execution to keep earnings growth robust. We believe incremental BOT project wins can create further value.

Aggressive pursuit of new focus: Building up BOT assets

Sadbhav has identified investment in BOT projects as a new focus area and has four BOT road projects of which Ahmedabad Ring Road is the marquee asset contributing to nearly 70% of the total NPV (Rs5.3 bn). The total investment in BOT projects is Rs1.3 bn and we expect toll-based projects to generate equity IRR of 18%-30%. We believe Sadbhav's key strengths are its strong presence in western India, in-house execution ability and low financial leverage.

Revenue visibility of 26 months: Expect PAT CAGR of 60% over FY2007-10E

Sadbhav's Rs29 bn order book provides strong revenue and earnings visibility for the next 2-3 years. Roads (excluding captive BOT projects) account for 36% of the order book and irrigation for 16% of the order book. We expect revenues and PAT to grow at a CAGR of 47% and 60% over FY2007-10E to Rs15.3 bn and Rs1 bn, respectively. We expect EBITDA margins to remain strong at 12.4% in FY2009E.

Key risks: Execution; slowdown in infrastructure investment

Our call on Sadbhav could be jeopardized by (1) delays in project execution, which could lead to cost escalation and deferred collections in the case of toll projects, (2) a slowdown in infrastructure spending and (3) aggressive competition.

BPCL, HPCL: Revised target prices on higher normalized earnings, value of investments

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- **Revised normalized earnings and valuation for likely removal of octroi, higher value of investments**
- **Difficult to forecast earnings given high under-recoveries but likely adequate support from the government**
- **Valuations continue to be attractive on long-term parameters or replacement value**

We have revised our normalized EBITDA and fair valuations of BPCL and HPCL to factor in (1) a potential abolishment of octroi duty (a form of tax levied by municipal bodies) on crude oil in Maharashtra and (2) higher value of investments. We see the increasing likelihood of the removal of octroi duty in Maharashtra given (1) likely implementation of a GST in India in from April 1, 2010 and (2) recent decision of the Maharashtra government to remove octroi duty on all products other than oil as an interim step. As highlighted previously, the removal of octroi duty on crude oil will have a large positive impact on the refining margins of the Mumbai refineries of BPCL and HPCL. We note that the current 3% octroi duty on crude oil depresses the refining margins of the aforesaid refineries by US$2.1/bbl (at US$70/bbl crude oil price). Our revised target prices for BPCL and HPCL are Rs450 and Rs400, respectively versus Rs375 and Rs300, respectively, previously and upgraded BPCL to ADD from REDUCE and maintain ADD rating on HPCL. Our 12-month target prices are based on 40% discount to 5X normalized EBITDA plus value of investments to factor in government policy-related earnings risks. Key downside risks stem from higher-than-expected net under-recoveries.

Octroi removal could be a big positive for the Mumbai refineries of BPCL and HPCL. Exhibit 1 gives the likely impact of removal of octroi on crude oil in Maharashtra on the earnings of BPCL and HPCL. Based on the current 3% octroi on crude oil in Mumbai and US$70/bbl crude price, we compute a pre-tax impact of Rs7.3 bn (12 mtpa crude throughput) for BPCL and Rs4.5 bn for HPCL (7.4 mtpa crude throughput). The EPS impact works out to Rs13.3 and Rs8.7 for BPCL and HPCL, respectively. We have revised our normalized earnings to factor the upside arising from the likely removal of octroi since we expect octroi duty to be removed over the next two years. The Maharashtra government has already started the process and decided to remove octroi duty on products other than oil. The Gujarat government has removed octroi on all products from November 15, 2007. We believe it is only fair that our normalized earnings reflect the potential removal of octroi duty particularly since we factor in large losses in perpetuity by building in a 40% discount to the fair valuation of the stocks.

Exhibit 2 shows our estimates of normalized earnings of BPCL and HPCL after factoring in removal of octroi duty on crude oil. We also clarify that the removal of octroi duty would have no impact on the companies' marketing losses; there is no octroi on products practically as the Mumbai-based refineries of BPCL and HPCL meet the city's fuel requirements. We believe the removal of octroi and other forms of indirect tax are critical to the implementation of the Goods and Services Tax (GST) regime in the country from April 1, 2010. The central government has already taken a decision on this issue and various state governments including the Maharashtra government have taken steps/taking steps to comply with the new regime. Hence, we do not see risk to our assumption of removal of octroi in Maharashtra over the next two years.

Energy

BPCL.BO, Rs439	
Rating	ADD
Sector coverage view	Neutral
Target Price (Rs)	450
52W High -Low (Rs)	470 - 255
Market Cap (Rs bn)	143.8

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	965.6	981.5	980.5
Net Profit (Rs bn)	18.9	15.3	9.3
EPS (Rs)	52.3	42.4	25.6
EPS gth	*578.0*	*(18.9)*	*(39.6)*
P/E (x)	8.4	10.3	17.1
EV/EBITDA (x)	4.1	4.6	6
Div yield (%)	4.0	4.0	2.4

Shareholding, September 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	64.3	-	-
FIIs	11.4	0.2	(0.2)
MFs	2.7	0.2	(0.1)
UTI	-	-	(0.3)
LIC	11.0	0.9	0.6

Energy

HPCL.BO, Rs328	
Rating	ADD
Sector coverage view	Neutral
Target Price (Rs)	400
52W High -Low (Rs)	334 - 223
Market Cap (Rs bn)	111.2

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	890.0	876.9	880.0
Net Profit (Rs bn)	13.5	9.1	9.2
EPS (Rs)	40.0	26.8	27.2
EPS gth	*503.8*	*(33.1)*	*1.7*
P/E (x)	8.2	12.2	12.0
EV/EBITDA (x)	5.0	6.4	5.5
Div yield (%)	5.5	3.0	3.0

Shareholding, September 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	51.0	-	-
FIIs	14.0	0.1	(0.1)
MFs	5.2	0.3	0.1
UTI	-	-	(0.2)
LIC	16.5	1.0	0.7

Earnings uncertainty prevails but government would likely provide adequate support as it has done in the past. The Group of Ministers (GoM) on commodity pricing will meet on December 14 to consider various options for compensation to the downstream oil companies, which may include (1) hike in auto fuel prices, (2) issue of additional oil bonds in addition to Rs235 bn worth of oil bonds already budgeted for FY2008E based on the government estimate of gross under-recoveries of Rs549 bn for FY2008E; the petroleum ministry has sought additional oil bonds of Rs55 bn and (3) cut in excise duties. We do not expect government response (if any) to result in a big positive earnings surprise for FY2008E given the likely large gross under-recoveries in FY2008E (see Exhibit 3). Nonetheless, we believe that the government would provide adequate assistance to support the earnings of the downstream companies at 'reasonable' levels, as it has done in the past. We rely on valuations based on normalized earnings as it is difficult to estimate earnings for FY2008E and FY2009E given the difficult operating environment and the government's limitations in addressing the subsidy issue.

Exhibit 4 gives our estimate of net under-recoveries (gross under-recoveries net of oil bonds and payment from upstream oil companies) of the downstream oil companies in FY2008E. We currently assume that the upstream companies will share 33.33% of the subsidy burden and the government will issue oil bonds worth Rs235 bn for FY2008E.

Valuation of integrated R&M stocks continues to be reasonable in the context of long-term valuation parameters or replacement value. Exhibit 5 shows that the downstream stocks continue to be inexpensive on P/B and EV/GCI. BPCL and HPCL are trading at 1.3X and 1.0X FY2008E book. We do not expect the book value to deteriorate and clarify that the book value is anyway low due to full depreciation of a large portion of the assets. Exhibit 6 gives our estimated replacement value for R&M companies broken down by various assets and as can be seen, BPCL and HPCL trade at large discounts to our estimated replacement values. Also, as highlighted for long by us, our estimated fair valuation of the refining business, investments, CWIP and lubes business exceeds the enterprise value of the stocks. This would suggest that the marketing assets are 'free'.

Removal of octroi duty on crude oil will be a big positive for the Mumbai refineries of BPCL and HPCL

Impact of removal of octroi duty in Maharashtra on the earnings of BPCL and HPCL

	BPCL	HPCL
Throughput of Mumbai refinery (mtpa)	12.0	7.4
Crude price (US$/bbl)	70.0	70.0
Exchange rate (Rs/USD)	39.4	39.4
Octroi (%)	3.0	3.0
Impact of octroi removal on pre-tax profits (Rs mn)	**7,266**	**4,480**
Impact of octroi removal on EPS (Rs)	**13.3**	**8.7**

Source: Kotak Institutional Equities estimates.

Our normalized earnings estimates are significantly higher versus actual forecasts

Comparison of normalized marketing margins with FY2009 estimates (Rs/ton)

	BPCL		HPCL	
	2009E	Normalized	2009E	Normalized
LPG	(10,000)	1,500	(10,000)	1,500
Naphtha	2,000	500	2,000	500
Gasoline	(2,750)	1,700	(2,750)	1,700
Jet fuel	2,000	1,400	2,000	1,400
Kerosene	(16,250)	600	(16,250)	600
Diesel	(1,000)	1,500	(1,000)	1,500
Light diesel oil	1,000	500	1,000	500
Low sulphur heavy stock	1,600	500	1,600	500
Fuel oil	1,600	500	1,600	500
Bitumen	1,800	1,000	1,800	1,000
EPS (Rs)	**27.2**	**72.5**	**27.2**	**70.4**
EBITDA (Rs bn)	**25.3**	**47.9**	**25.3**	**47.4**
EV (5X normalised EBITDA) (Rs bn)		240		237
Value of investments (Rs bn)		91		59
Net debt (Rs bn)		63		93
Equity value (Rs/share)		**739**		**602**
Equity value at 40% discount (Rs/share)		**443**		**391**

Note:
(a) Our normalized earnings estimates are based on normalized marketing margins, actual refining margin estimates and likley impact of octroi removal for Mumbai refinerires of BPCL and HPCL for FY2009.

Source: Kotak Institutional Equities estimates.

Gross under-recovery in FY2008E will be significantly higher than FY2007 levels

Estimation of gross under-recovery in FY2008E

	FY2007	FY2008E
Government estimate of gross under-recovery	**494**	**549**
KIE estimated gross under-recovery in April-December 2007		442
KIE estimated gross under-recovery in December 2007 (a)		85
KIE estimated gross under-recovery in balance of FY2008 (b)		254
KIE estimated gross under-recovery in FY2008E		**696**
Subsidy loss on diesel in FY2007 or in December 2007 (Rs/l)	2.0	7.3
Subsidy loss on gasoline in FY2007 or in December 2007 (Rs/l)	1.6	7.2
Subsidy loss on LPG in FY2007 or in December 2007 (Rs/cylinder)	187	328
Subsidy loss on kerosene in FY2007 or in December 2007 (Rs/l)	16.5	22.0
Crude oil (Dated Brent) price in FY2007 or in November 2007 (US$/bbl	**64.8**	**92.6**

Note:
(a) Based on November international product prices and November retail domestic price; Dated Brent price in November 2007 was US$92.6/bbl.
(b) Gross under-recovery for balance of FY2008 computed using December 2007E gross under-recovery.

Source: MOPNG, Kotak Institutional Equities estimates.

R&M companies likely worse off in FY2008E versus FY2007

Estimation of breakdown of gross under-recovery, March fiscal year-ends, 2006-2008E (Rs bn)

	2006	2007	2008E
Dated Brent crude oil price (US$/bbl)	57	65	79
Subsidy loss	**400**	**494**	**696**
Payment by government (oil bonds)	**115**	**241**	**235**
Share of BPCL	22	53	53
Share of HPCL	23	49	49
Share of IOCL	70	138	133
Net under-recovery of oil companies	**285**	**253**	**461**
Share of refining companies	27	—	—
Share of upstream companies	**140**	**205**	**232**
Share of ONGC	120	170	193
Share of GAIL	11	15	17
Share of Oil India	10	20	22
Net under-recovery of R&M companies (BPCL, HPCL, IOCL)	**118**	**48**	**229**
Pre-tax profits of R&M companies	**74**	**96**	

Source: Kotak Institutional Equities estimates.

Indian downstream oil stocks are inexpensive on long-term valuations

P/B and EV/GCI for BPCL/HPCL

	2007		2008E		2009E	
	BPCL	HPCL	BPCL	HPCL	BPCL	HPCL
Stock price (Rs)	439	328	439	328	439	328
Year-end book value (Rs)	322	325	350	344	367	365
P/B (X)	**1.4**	**1.0**	**1.3**	**1.0**	**1.2**	**0.9**
ROAE (%)	16.3	14.9	12.6	8.0	7.2	7.7
EV (Rs bn)	175	144	170	168	173	162
Gross cash invested (Rs bn)	218	211	233	252	254	262
EV/GCI (X)	**0.8**	**0.7**	**0.7**	**0.7**	**0.7**	**0.6**
Cash returns (Rs bn)	25	16	16	11	17	21
CROCI (%)	11.3	7.7	6.8	4.4	6.7	7.9

Note:

(a) Book value of Indian R&M stocks may be depressed due to full depreciation of certain assets (old refineries, LPG cylinders).

Source: Kotak Institutional Equities estimates.

BPCL and HPCL are attractively valued versus replacement values

Enterprise value versus replacement cost of BPCL and HPCL (Rs mn)

		BPCL		HPCL	
	Rs/unit	Details	Repl. cost	Details	Repl. cost
Replacement cost calculation					
Refining capacity (mtpa)	7,000	19.5	136,500	18.0	126,210
Product pipeline network (kms)	12.5	1,379	17,238	2,131	26,638
LOBS capacity (000 tpa)	12	180	2,160	335	4,020
Retail outlets (#)-land		7,537	7,021	7,909	7,370
Retail outlets (#)-fixed assets		7,537	15,074	7,909	15,818
Tanks, terminals etc. (mn kilo liters)	6,000	3.3	19,620	4.0	23,844
LPG cylinders (100% of gross block)			32,626		12,650
LPG bottling capacity (000 tpa)	10	2,082	20,820	2,154	21,540
LPG import capacity (000 tpa)	3	—	—	1,600	4,800
Capital WIP			8,523		15,059
Fixed assets total			259,582		257,948
Investments (@ market value)			127,108		90,329
Net working capital			14,931		12,584
Value of lubes business (@ 1X sales)			10,904		18,582
Replacement cost			**412,525**		**379,443**
Enterprise value calculation					
Outstanding shares (mn)		362		339	
Market price		439		328	
Market capitalization (Rs mn)			158,608		111,177
Net debt (Rs mn)			99,653		104,307
Enterprise value (Rs mn)			**258,261**		**215,485**
Current EV/RC (X)			0.63		0.57
Implied market price at EV/RC=60%			409		364
Implied market price at EV/RC=80%			637		588
Implied market price at EV/RC=100%			**865**		**812**

Source: Kotak Institutional Equities Estimates.

Energy

GAIL.BO, Rs517	
Rating	SELL
Sector coverage view	Neutral
Target Price (Rs)	380
52W High -Low (Rs)	522 - 243
Market Cap (Rs bn)	437.5

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	160.5	228.5	241.3
Net Profit (Rs bn)	21.4	24.1	24.9
EPS (Rs)	25.3	28.6	29.4
EPS gth	*(9.5)*	*12.9*	*3.1*
P/E (x)	20.5	18.1	17.6
EV/EBITDA (x)	12.0	10.8	10
Div yield (%)	1.9	1.9	2.1

Shareholding, September 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	57.3	-	-
FIIs	22.0	0.8	0.0
MFs	1.6	0.4	(0.4)
UTI	-	-	(0.8)
LIC	6.2	1.3	0.5

GAIL (India): Any news, announcement, event is a positive unless proven otherwise these days

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- **Surge in stock price baffling given no real change in business; in fact, risks exist from draft gas pipeline transportation regulations**
- **GAIL may not benefit significantly from RIL's KG D-6 gas (20 mcm/d of gas in best-case scenario, practically nil in worst-case scenario)**
- **Reiterate SELL rating with 12-month target price of Rs380**

We are perplexed by the continuous surge in stock price of GAIL (India) over the past few weeks. We attribute the increase in stock price to street's expectations of likely steep increase in GAIL's earnings from its proposed investment (Rs180 bn) in new pipelines and increased transportation volumes. We expect GAIL's gas transportation volumes to possibly increase beyond FY2010E (likely very modest increase until then) but our view of the stock is tempered by (1) likely negative impact due to regulations on gas pipeline transportation, (2) unsustainable nature of earnings of LPG and petrochemical businesses and (3) short-term negative surprise from potential increase in subsidy burden. We believe that investment in new pipelines and increase in transportation volumes will be necessary to maintain earnings at current level, given the possible negative impact of the regulations for the gas transmission business. We retain our 12-month SOTP-based target price to Rs380. Key upside risks stem from lower-than-expected subsidy losses and stronger-than-expected commodity prices.

Street is likely positive about the strong volume growth (beyond FY2010E) but is ignoring negatives (regulations, quality of earnings). We believe that the street is positive on the stock on account of the likely steep volume growth from its proposed investment in new pipelines. However, it seems that the street is not taking the likely negative impact of the regulations into cognizance. The stock has run up by 24% (Rs85 bn increase in market capitalization) since the issue of the draft regulations for tariffs for natural gas pipelines (November 29, 2007). We do not believe that there has been any major development to justify the recent re-rating of the stock other development on PMT fields (neutral at best) and agreements with Reliance Industries (for petrochemical plants outside India) and Reliance Gas Transportation Infrastructure (gas transportation of Reliance's KG basin gas). We do not attach much significance to the first MOU and the second one (gas transmission agreement) has been expected for some time since GAIL and RIL had signed an MOU in March 2007. However, this may not enhance GAIL's transportation volumes significantly, in our view.

On the other hand, the street seems unconcerned about any negative fall-out of the draft regulations circulated by the Petroleum and Natural Gas Regulatory Board (PNGRB). We do not understand the implications fully but understand that it cannot be a positive for GAIL's extant gas transportation business versus the extant regulations.

GAIL may not even get any/much of RIL's 80 mcm/d gas production from KG D-6 block; expectations about steep increase in gas transportation volumes a bit premature. We do not see GAIL's transportation volumes improving significantly even after RIL starts gas production from its KG D-6 block. Reliance will use 20-25 mcm/d of gas for internal consumption; this volume will not flow through GAIL's network as it will flow through RGTIL's East-West pipeline and GSPL's network in Gujarat. Reliance will sell some amount of the gas in the KG basin area through GAIL's pipelines but presumably this will not benefit GAIL's revenues/profits (tariffs will likely re-adjust down, we would think), to refineries of BPCL (Mumbai) and HPCL (Mumbai, Visakh), to industrial units along RGTIL's East-West pipeline and to industries, power and fertilizer plants in Maharashtra (around Mumbai) and in South Gujarat. We compute the total at around 40 mcm/d and note that the bulk of this 40 mcm/d will not even flow through GAIL's pipeline system. Also, GAIL will need to develop a parallel HVJ system (which it has planned at about Rs75 bn capex) to carry additional gas to the major gas consumption centers in North-West India but this will not happen before FY2011E; also, GAIL would need to be sure about gas supply to start construction. GAIL's extant HVJ and DV pipelines do not have spare capacity.

GAIL's dependence on RIL's D-6 block for gas supply could be exposed if RIL has to honor its gas supply agreements with NTPC and RNRL. We assume this would be the case since the dispute is not on volumes but on pricing; if the price dispute is not resolved (amicably or legally), RIL cannot even sell the gas to outside parties. Thus, we believe RIL may need to supply gas to NTPC (12 mcm/d) and RNRL (minimum 28 mcm/d) as and when the corresponding power plants come up. The former will not require GAIL's network (GTIL's East-West pipeline will serve the purpose) and RNRL may construct a Kakinada-Dadri pipeline to minimize on transportation costs, particularly if the cost of gas (wellhead) is settled at US$4.2/mn BTU and not US$2.34/mn BTU. We do not think it would make sense for Reliance Power to take gas at Dadri through RGTIL's East-West pipeline and then through GAIL's 'new' HVJ system through the Vijaipur-Dadri link. This circuitous route would add significantly to the cost of gas. This would make GAIL's proposed 'new' HVJ system practically redundant unless India discovers more gas in the next 2-3 years.

Impact of regulations—no clarity on old pipelines. Exhibit 1 shows the likely earnings of pipeline project based on the draft regulations issued by PNGRB. We see value creation (enhancement) of 0.22-0.64X the equity investment in a gas transportation project. We analyze the earnings of a pipeline project under various financing assumptions; a higher NPV can be achieved if the project is leveraged. However, we doubt GAIL is going to use significant leverage given its historical financing pattern and large cash flows. We discuss below the likely impact of the regulations on the existing as well as the new pipelines of GAIL.

Existing pipelines—basis of setting tariff not clear but capital employed low given depreciation. The earnings on the existing pipelines would depend on the capital employed that will be used for GAIL's old and largely depreciated pipeline network. We note that GAIL has already recovered a significant part of the initial capex of the pipelines under the previous regulatory regimes (12% equity IRR until FY2005 and 12% ROE from FY2006). In fact, the initial HVJ pipeline (excluding expansion done in FY1997-98) is fully depreciated and we would assume has recovered most of the capex during its 20 years of operations. If the regulator uses a low capital employed for a portion of GAIL's extant pipeline network to compute future tariffs, we can expect a steep decline in the profits of the GAIL's gas transportation segment. The pipeline segment is the highest contributor to GAIL's EBIT and it also enjoys very high ROCE (see Exhibit 2).

We note that we model a constant tariff (other than a modest increase for inflation in costs) for GAIL's extant HVJ, DV and DUPD pipelines throughout our forecast period. GAIL receives about Rs0.96/cu m as composite tariff for the HVJ and DV pipelines currently. As such, we see significant downside to our earnings estimates from potential lower tariff for the HVJ and DV pipelines due to use of a lower capital employed base.

New pipelines—a regulated business, by definition, cannot have very high ROE or create huge value. The draft regulations for natural gas pipelines lay down the methodology for computation of the return on the capital employed as well as the tariff to be charged in case of a natural gas pipeline. The regulations lay down for a fixed tariff to be charged over the economic life of the project based on a reasonable rate of return on capital employed. This methodology means that GAIL's tariff for a pipeline would remain the same over the economic life of the pipeline; however, the decline in earnings is implicitly captured in the declining cash flows due to the declining capital employed base. We note that the capital employed will decline every year due to depreciation and the return on capital employed (RROR X capital employed) will also decline every year.

Other factors which provide downside risk to the stock. We have previously highlighted our concerns regarding (1) short-term negative surprise from potential increase in subsidy burden and (2) unsustainable nature of earnings of LPG and petrochemical businesses.

Subsidy burden—somebody has to bear it. We believe that high crude prices will continue to create uncertainty about GAIL's subsidy burden and earnings without a proper compensation and subsidy-sharing system. We believe significant upside risks exist given that the upstream companies can absorb higher subsidy losses compared to the downstream companies at higher crude oil prices. In particular, we believe that the GAIL would incur a higher subsidy burden in 2HFY08 versus 1HFY08 given that the government's estimate of FY2008 gross under-recoveries (Rs549 bn) will likely be exceeded by a significant amount due to significantly higher crude prices in 2HFY08 versus 1HFY08 (see Exhibit 3).

Unsustainable nature of earnings of LPG and petrochemical businesses; a generous ONGC and government policy helps. We had highlighted in our note November 28, the likely negative impact of higher gas price on the LPG and petrochemical businesses of GAIL. If government uses the revised price of PMT (at US$5.7/mn BTU) as the benchmark for the price of gas for non-fertilizer and non-power sectors, then it will be significantly negative for earnings of GAIL's LPG and petrochemical segments. We note that GAIL benefits immensely from high crude prices in that its sales price of LPG and petrochemicals increase while input (natural gas) prices remain constant (see the exhibit on segment ROCE). The arbitrage is particularly high at current crude prices.

We are reluctant to believe that GAIL would benefit from the arbitrage between oil and gas prices in perpetuity. We attempt to capture the potential downside risk though low multiples for the LPG and petrochemical segments in our SOTP valuation (Exhibit 4). We use 4X FY2009E EBITDA (unadjusted for subsidy losses) although we suspect the market may be willing to ascribe higher multiples, which may explain higher street expectations from the stock.

The entity can use leverage to enhance the NPV of the pipeline project
Computation of earnings based on draft regulations on natural gas transmission (Rs)

Sceanrio 1: Assuming 100% equity financed project																							
Year		**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20**	**21**	**22**	**23**
Capital expenditure		(20)	(40)	(40)																				
Opening capital employed					100	95	90	85	80	75	70	65	60	55	50	45	40	35	30	25	20	15	10	5
Less: Depreciation					5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5
Closing capital employed					95	90	85	80	75	70	65	60	55	50	45	40	35	30	25	20	15	10	5	—
Average capital employed (A)					98	93	88	83	78	73	68	63	58	53	48	43	38	33	28	23	18	13	8	3
Pre-tax return on capital employed (A) X (B)					21	20	19	17	16	15	14	13	12	11	10	9	8	7	6	5	4	3	2	1
Less: Tax					—	—	—	—	—	—	—	—	—	—	(3)	(3)	(3)	(2)	(2)	(2)	(1)	(1)	(1)	(0)
Add: Book depreciation					5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5
Cash flow		(20)	(40)	(40)	26	25	24	22	21	20	19	18	17	16	12	11	10	10	9	8	7	7	6	5
Discounted CF		(18)	(32)	(28)	16	14	12	10	9	7	6	5	4	4	2	2	2	1	1	1	1	1	0	0
NPV	**22**																							
Equity value enhancement (X)	**0.22**																							

Sceanrio 1: Assuming debt equity ratio of 1:1																							
Year		**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20**	**21**	**22**	**23**
Capital expenditure		(20)	(40)	(40)																				
Debt infusion/(repayment)		10	20	20	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)
Capital employed (A)					100	95	90	85	80	75	70	65	60	55	50	45	40	35	30	25	20	15	10	5
Less: Depreciation					5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5
Closing capital employed					95	90	85	80	75	70	65	60	55	50	45	40	35	30	25	20	15	10	5	—
Average capital employed					98	93	88	83	78	73	68	63	58	53	48	43	38	33	28	23	18	13	8	3
Pre-tax return on capital employed (A) X (B)					21	20	19	17	16	15	14	13	12	11	10	9	8	7	6	5	4	3	2	1
Less: Interest					(4)	(4)	(4)	(4)	(3)	(3)	(3)	(3)	(3)	(2)	(2)	(2)	(2)	(1)	(1)	(1)	(1)	(1)	(0)	(0)
Profits before tax					16	15	15	14	13	12	11	10	10	9	8	7	6	5	5	4	3	2	1	0
Less: Tax					—	—	—	—	—	—	—	—	—	—	(3)	(2)	(2)	(2)	(2)	(1)	(1)	(1)	(0)	(0)
Profits after tax					16	15	15	14	13	12	11	10	10	9	5	5	4	4	3	2	2	1	1	0
Add: book depreciation					5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5
Cash flow to equity		(10)	(20)	(20)	19	18	17	16	15	15	14	13	12	11	8	7	7	6	6	5	4	4	3	3
Discounted CF		(9)	(16)	(14)	12	10	9	7	6	5	4	4	3	3	2	1	1	1	1	1	0	0	0	0
NPV	**32**																							
Equit value enhancement (X)	**0.64**																							

Key assumptions	
Post-tax RRoR	14%
Pre-tax RROR (B)	21%
Depreciation rate	5%
Interest rate	9%
Cost of equity (%)	12%

Note:
(a) We have assumed tax exemption for the pipeline for a period of 10 years from the commencement of operation.

Source: Kotak Institutional Equities estimates.

GAIL's earnings face downside risk due to regulations, correction in government policy
Return on capital employed for various segments of GAIL

	Transmission	Petrochemicals	LPG and liquid HCs
FY2007			
EBIT (Rs mn)	17,060	9,545	1,022
EBIT * (1-t)	12,215	6,834	731
Capital employed (Rs mn)	47,521	19,128	8,970
ROCE (%)	**25.7**	**35.7**	**8.2**
1HFY08			
Annualized EBIT (Rs mn)	17,408	13,251	8,438
EBIT * (1-t)	11,780	8,967	5,710
Capital employed (Rs mn)	62,137	18,312	10,804
ROCE (%)	**19.0**	**49.0**	**52.8**

Source: Company, Kotak Institutional Equities.

The under-recoveries will likely be significantly higher in FY2008 compared to FY2007

Estimation of subsidy under-recovery in FY2008E (Rs bn)

	2006	2007	2008E
Dated Brent crude oil price (US$/bbl)	57	65	79
Subsidy loss	**400**	**494**	**696**
Payment by government (oil bonds)	**115**	**241**	**235**
Share of BPCL	22	53	53
Share of HPCL	23	49	49
Share of IOCL	70	138	133
Net under-recovery of oil companies	**285**	**253**	**461**
Share of refining companies	27	—	—
Share of upstream companies	**140**	**205**	**232**
Share of ONGC	120	170	193
Share of GAIL	11	15	17
Share of Oil India	10	20	22
Net under-recovery of R&M companies (BPCL, HPCL, IOCL)	**118**	**48**	**229**
Pre-tax profits of R&M companies	**74**	**96**	

Source: Kotak Institutional Equities estimates.

We value GAIL stock at Rs380 per share

Sum-of-the-parts valuation of GAIL, FY2009 basis (Rs bn)

	Valuation base (Rs bn)		Multiples (X)		EV (Rs bn)		
	Replacement cost	EBITDA	EV/RC	EV/EBITDA	Replacement cost basis	EBITDA basis	EV (Rs/share)
Natural gas/LPG transportation		19		6.0		114	135
LPG production		22		4.0		88	104
Petrochemicals		6		4.0		25	29
Oil and gas upstream	17		1.00		17		21
Subsidy sharing scheme		(12)		1.0		(12)	(14)
Investments	84		0.80		67		79
ONGC shares	58		0.80		46		55
Others	26		0.80		20		24
Total		**35**				**214**	**353**
Net debt/(cash)					(22)	(22)	(26)
Implied value of share (Rs/share)							**379**

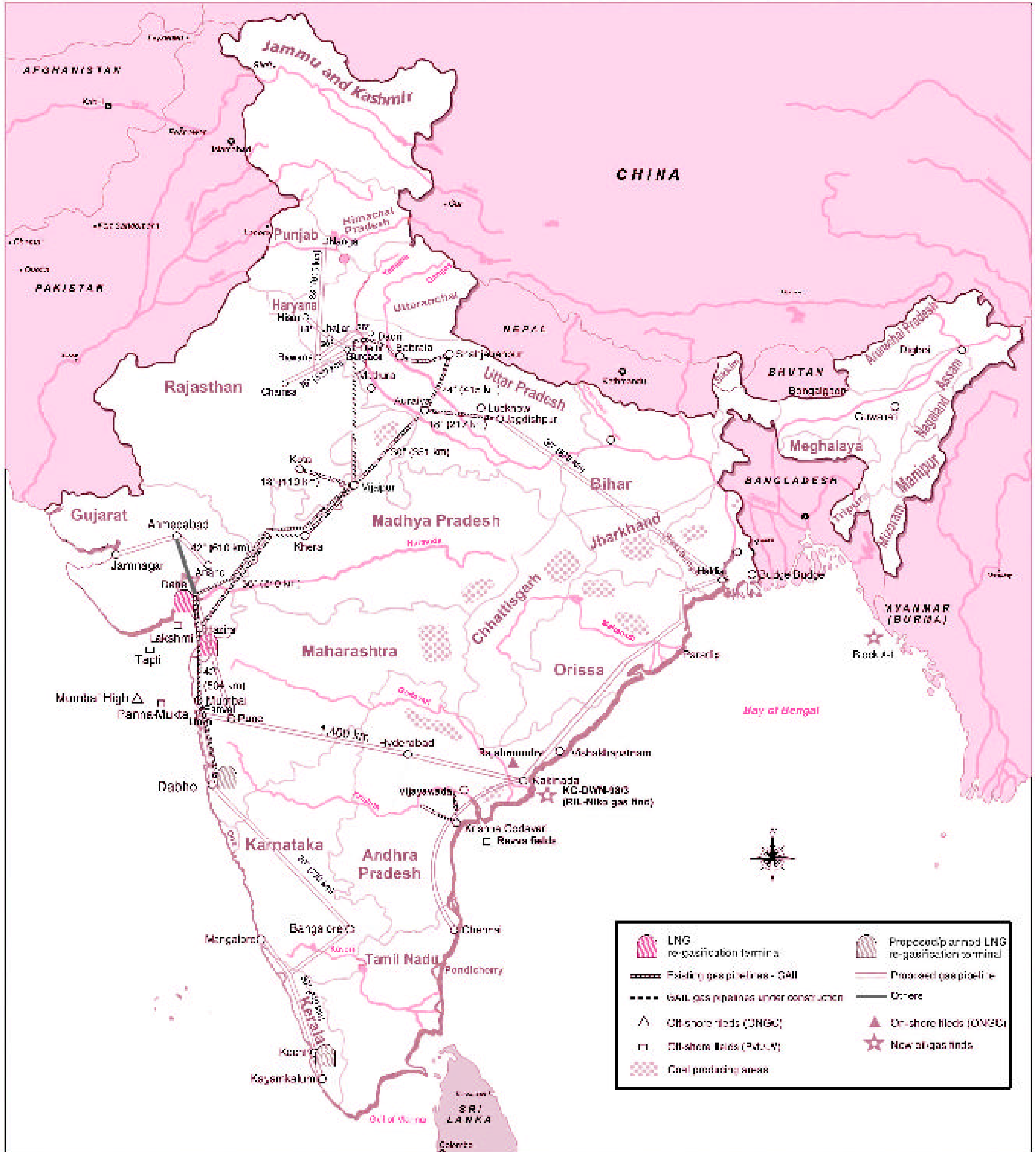
Source: Kotak Institutional Equities estimates.

GAIL (India) Ltd: Profit model, balance sheet, cash model of GAIL 2004-2010E, March fiscal year-ends (Rs mn)

	2004	2005	2006	2007	2008E	2009E	2010E
Profit model (Rs mn)							
Net sales	116,395	135,914	163,513	160,472	228,498	241,293	264,090
EBITDA	**30,667**	**36,040**	**35,731**	**29,896**	**35,839**	**37,277**	**34,945**
Other income	2,440	3,491	4,555	5,450	4,796	4,956	6,916
Interest	(1,380)	(1,341)	(1,174)	(1,071)	(726)	(656)	(656)
Depreciation	(6,640)	(9,467)	(5,595)	(5,754)	(6,084)	(6,516)	(6,556)
Pretax profits	25,088	28,723	33,518	28,521	33,825	35,062	34,649
Tax	(8,373)	(8,898)	(9,221)	(7,941)	(7,397)	(9,252)	(9,669)
Deferred taxation	(1,078)	(277)	(445)	(190)	(2,279)	(921)	(446)
Net profits	**18,693**	**19,539**	**23,101**	**23,867**	**24,148**	**24,889**	**24,534**
Earnings per share (Rs)	**22.1**	**23.1**	**27.3**	**28.2**	**28.6**	**29.4**	**29.0**
Balance sheet (Rs mn)							
Total equity	74,452	86,261	99,733	113,929	128,183	142,189	154,851
Deferred taxation liability	12,276	12,552	12,997	13,187	15,466	16,387	16,833
Total borrowings	21,335	19,974	19,166	13,379	11,000	11,000	11,000
Current liabilities	30,302	34,742	37,522	45,512	43,726	45,630	49,401
Total liabilities and equity	**138,364**	**153,529**	**169,418**	**186,007**	**198,376**	**215,206**	**232,085**
Cash	15,680	34,468	44,959	26,604	10,722	33,302	55,208
Other current assets	25,391	29,671	28,309	50,851	62,867	61,823	61,541
Total fixed assets	89,574	81,550	81,716	93,913	110,149	105,443	100,697
Investments	7,720	7,840	14,434	14,638	14,638	14,638	14,638
Total assets	**138,364**	**153,529**	**169,418**	**186,007**	**198,376**	**215,206**	**232,085**
Free cash flow (Rs mn)							
Operating cash flow, excl. working capital	23,954	26,912	25,165	23,920	27,715	27,369	24,620
Working capital changes	580	49	5,950	(10,151)	(13,802)	2,948	4,053
Capital expenditure	(26,924)	(1,472)	(5,811)	(20,449)	(22,320)	(1,810)	(1,810)
Investments	(841)	(120)	(6,462)	(205)	—	—	—
Other income	1,826	2,416	3,995	3,884	4,796	4,956	6,916
Free cash flow	**(1,405)**	**27,787**	**22,837**	**(3,002)**	**(3,610)**	**33,463**	**33,779**
Ratios (%)							
Debt/equity	24.6	20.2	17.0	10.5	7.7	6.9	6.4
Net debt/equity	6.5	(14.7)	(22.9)	(10.4)	0.2	(14.1)	(25.7)
ROAE (%)	23.2	21.1	21.8	19.9	17.8	16.5	14.9
ROACE (%)	**16.2**	**18.0**	**19.7**	**15.5**	**16.7**	**15.6**	**14.2**

Source: Kotak Institutional Equities estimates.

Existing and proposed gas pipeline in India



Source: Company, Kotak Institutional Equities.

Economy

Sector coverage view	N/A

Fed cuts 25 bps: Market disappointment is an overreaction as more cuts on anvil later

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- **We believe the Fed has been sensible in cutting the FFR target and discount rate by 25 bps each**
- **FOMC statement is sufficiently dovish, leaves room for further cuts**
- **We see FFR trough at 3.25% in 3QCY08; RBI likely to cut in 1QCY08**

We believe the Federal Open Markets Committee (FOMC) statement accompanying its rate cut decision is sufficiently dovish. It leaves ample room for further cuts. We expect the Fed funds rate (FFR) target to be lowered to 3.25% by the end of 3QCY08. Later, the Fed could withdraw some of the monetary accommodation if the US economy rebounds or if the core inflation trajectory picks up.

Fed cuts FFR target and discount rate by 25 bps each—sensible, in our view

The FOMC on December 11 cut its Federal funds rate target by 25 bps to 4.25% from 4.5%. In a related action, the Board of Governors cut the discount rate 25 bps from 5.0% to 4.75%. With this the Fed has lowered its Fed funds target 100 bps from 5.25% in a span of a little over four months (see Exhibit).

The Fed decision of 25 bps cut is in line with our expectations—India Daily comment of *November 21, 2007, "FMOC's new improved minutes reaffirm growth concerns"*. On December 6, 2007, we had explained why the Fed may find it difficult to live up to the market expectations of a 50 bps cut.

Possible explanations for the Fed not cutting FFR or the discount rate by 50 bps

1. A 50 bps rate cut could mean that markets are dictating the Fed into endogenous rate cuts.
2. The Fed may require more aggressive rate cuts ahead to restore confidence during any future liquidity or solvency problems in the financial markets.
3. The quick depreciation of US dollar has inflationary potential and carries the risk of the US dollar losing sheen if countries in the Gulf or elsewhere exit from the dollar peg.
4. Though a segment of the market may have expected a 50 bps cut in the discount rate, it was not really much of an option, as the discount window (for borrowings from the Fed) is usually set at a 100 bps premium over the Fed funds rate (for overnight borrowing/lending in the inter-bank market). This premium was already reduced to 50 bps after the Fed cuts discount rate 50 bps on August 17, 2007.

FOMC Statement sufficiently dovish

We believe that the statement accompanying the FOMC decision is sufficiently dovish. The market disappointment is, in our view, an expected overreaction. The Fed has clearly signaled that it is giving a far greater weight to output than to inflation in the near term. This implies that the Fed is willing to lower interest rates further. The pace and extent of cuts would be calibrated to conditions in financial markets and real economy.

In our opinion, the two main aspects of the current Fed statement are as follows:

i. The Fed has clearly communicated its recognition of risks to growth and financial market stability. Consider its statement that *"Incoming information suggests that economic growth is slowing .... strains in financial markets have increased in recent weeks"*, which represents a clear shift from the October 31 FOMC statement *("economic growth was solid in the third quarter, and strains in financial markets have eased somewhat on balance")*.

ii. The key phrase from the October 31 statement that, *"the Committee judges that, after this action, the upside risks to inflation roughly balance the downside risks to growth"* has been dropped. This means that even after another 25 bps cut, the Fed weighs downside risks to growth more than the upside risks to inflation. The Fed has indicated that there is room for further cuts.

It may be added that the FOMC decision of December 11, was taken with one FOMC member (Eric Rosengren) voting against, preferring a 50 bps cut, in contrast to the October 31 meeting at which one FOMC member voted against, preferring no change in the FFR target.

Markets overreact

We believe that the Fed decision was sensible but markets have overreacted. Stocks plunged in the US on the day as the markets had already factored in cut of >25 bps.

- NYSE composite index fell 2.63%, led by NYSE financials falling by 3.98%
- DJIA fell 2.14%.
- NASDAQ fell 2.45%

We believe the Federal funds rate target is now close to the neutral rate (rate at which output grows at the potential rate in a non-inflationary manner), which in nominal terms is currently in the range of 4%-4.25%. As such, contingent upon the severity of financial stress and economic slowdown, we expect the Fed policy rate to be lowered by another 100 bps from here to a trough somewhere in 3QCY08. Another Fed rate cut can be expected on January 30, 2008, the size of which could depend on intermittent developments.

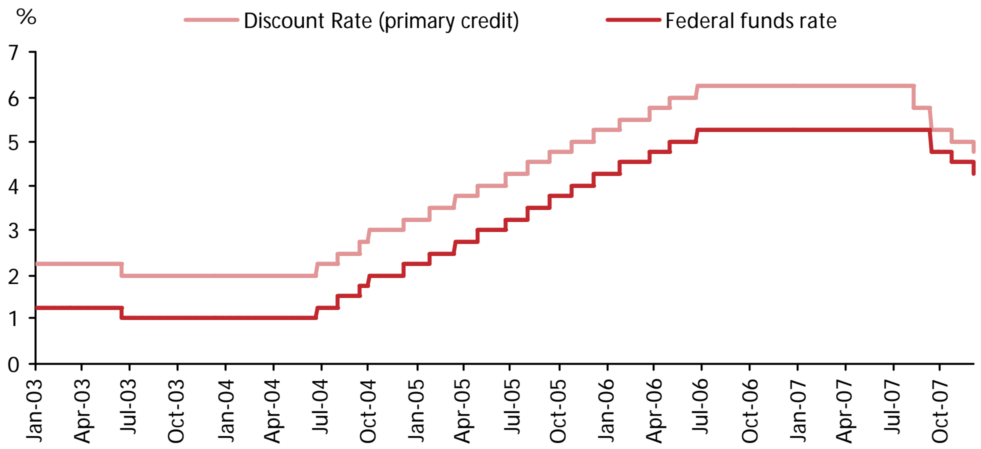
RBI policy rate cut a distinct possibility in 1QCY08

In aftermath of the policy rate cut by the Fed, we reiterate our view that RBI is likely to cut its policy rates in the Jan-Mar quarter. This would most likely be at the time of the Third Quarter Review of monetary policy on January 29, 2007. Our view is underpinned by:

- 2QFY08 quarterly GDP numbers, which have shown that growth is decelerating.
- Consumption demand is slowing down
- Consumer durables output has now contracted for five months in a succession.
- 2QFY08 corporate results have confirmed a significant slowdown in top line and bottom line growth.
- IIP growth is expected to decelerate significantly in 2HFY08. We reiterate that the IIP numbers due to be released tomorrow could show a very high growth in double digits. But, November onwards sustained deceleration in growth may occur with December IIP numbers due in February could be a trough of 4% or less.
- Liquidity could tighten in coming days on account of advance tax flows and remain tight on account of the larger-than-expected market borrowing program. National Small Savings (NSS) collections have negative so far this fiscal and are likely to require additional market borrowings by states.
- The interest rate differential between LAF repo rate and the FFR target is now already 350 bps and though RBI currently is more concerned with keeping rates high to keep asset prices in check, views could change if arbitrage flows accelerate.

More Fed easing ahead; quick small steps can cover the distance

Federal funds rate target: discount rate on primary credit facility



Source: Federal Reserve Board

Banking

Sector coverage view			Attractive

		Price, Rs	
Company	**Rating**	**11-Dec**	**Target**
SBI	ADD	2,446	2,000
HDFC	REDUCE	2,947	2,200
HDFC Bank	REDUCE	1,775	1,300
ICICI Bank	ADD	1,316	1,200
Corp Bk	BUY	446	470
BoB	ADD	399	375
PNB	BUY	667	620
OBC	REDUCE	283	240
Canara Bk	SELL	317	250
LIC Housing	ADD	387	345
Axis Bank	ADD	940	850
IOB	ADD	185	150
SREI	BUY	214	240
MMFSL	ADD	285	265
Andhra	BUY	106	120
IDFC	SELL	225	145
PFC	SELL	269	150
Centurion Banl	REDUCE	59	45
Federal Bank	ADD	328	330
J&K Bank	ADD	874	850
India Infoline	ADD	1,495	1,300
Indian Bank	SELL	219	145
Union Bank	BUY	207	230

Valuations have increased, revisiting recommendations on select stocks

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- **Expect an improvement in operational performance of banks on a sequential basis**
- **However, some stocks have run up ahead of fundamentals**
- **Revisiting recommendations on BOB, Indian Bank, IOB, J&K Bank, Federal Bank, CBOP**

Likely lower valuations, significant under-performance and expectation of improving operating environment has led to a sharp run up in PSU bank stocks over the last two months. PSU banks now trade at 1.2X APBR to 2.2X APBR FY2009, up from 1.1X and 1.5X APBR FY2009 two months back. We believe some stocks have run ahead of their operating fundamentals (Indian Bank, IOB, BoB, J&K Bank, Centurion Bank of Punjab) and are thus revising down our ratings on these stocks. However, we have a positive view on the sector - expect healthy credit growth and margin improvement qoq for banks (on the back of improving credit/deposit ratio and lower deposit rates yoy) and believe that investors should buy on any corrections. We have provided in Exhibit 1 the likely price target based on FY2010 earnings estimates across key banks.

Improving credit deposit ratio. Over the last two quarters the banking sector reported disappointing operating performance. Lower credit off-take, higher deposit rates resulted in margin pressure at banks. Recent data from RBI, however, shows:

1. An improvement in the incremental credit-deposit ratio of banks to 44% (over March 2007) compared to a 34% observed on October 26, 2007. This was driven by a marginal improvement in non-food credit growth to 24% yoy while deposit growth remained strong at around 25%yoy. (Exhibits 2 to 4) and
2. Reduction in the outstanding securities under the MSS to Rs1.7 tn (as on November 30, 2007) down from Rs1.8 tn (as on November 2, 2007) 'thereby reducing the need for the banking system to park its deposits in low yielding government securities.

We believe both these developments augur well for the margin of banks as on an incremental basis banks are deploying resources in higher yielding assets rather than in low yielding government securities.

…and softer rates positive for margin. Our channel checks on the deposit rates offered by various banks indicate that most of the banks have reduced their interest rates on deposits by 25-75 bps across maturities over the last two months. Corporation Bank and IOB are the most aggressive amongst public banks in cutting deposit rates, while ICICI Bank and HDFC Bank have also reduced their rates by 25-50 bps over the last month. The faster growth in deposits in comparison to advances in 1HFY08 provides lee way for the banking system to fund loan growth by rebalancing their asset portfolio rather than through aggressive deposit growth.

Exhibit 1: We revise our recommendations on certain stocks post the sharp run-up in their stock prices

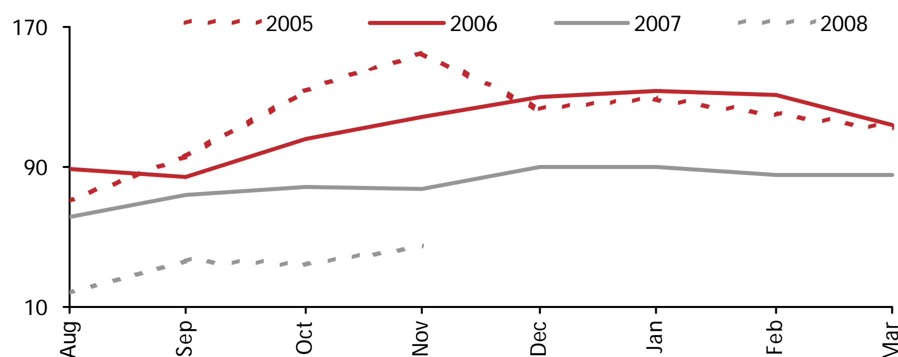
Recommendation and key assumptions for our fair price calculations

	Stock recommendations		Based on FY2009 earnings	Our assumptions for fair price based on FY2010 earnings				
	Previous	Current	Target price	Cost of equity	RoE in steady state	Earnings growth in the steady state	Dividend payout ratio - high growth phase	Fair value per share
			(Rs)	(%)	(%)	(%)	(%)	(Rs)
Public banks								
Andhra Bank	BUY	BUY	120	12.8	16.5	6.0	35.0	**145**
Bank of Baroda	BUY	ADD	375	13.0	15.0	6.0	20.0	**440**
Banking business	BUY	ADD	350					**387**
Canara Bank	SELL	SELL	250	13.3	14.0	6.0	15.0	**290**
Corporation Bank	BUY	BUY	470	13.0	16.0	6.0	20.0	**510**
Indian Bank	REDUCE	SELL	135	13.5	16.0	6.0	25.0	**170**
Indian Overseas Bank	BUY	ADD	150	13.0	16.5	6.0	20.0	**225**
Oriental Bank of Commerce	REDUCE	REDUCE	240	13.0	14.0	6.0	25.0	**260**
Punjab National Bank	BUY	BUY	620	12.8	16.5	6.0	25.0	**800**
Banking business	BUY	BUY	610					**735**
State Bank of India	ADD	ADD	2,000	12.5	17.0	6.0	25.0	**2,300**
Standalone bank	ADD	ADD	1,300					**1,470**
Union Bank	BUY	BUY	230	13.0	16.5	6.0	22.0	**265**
Old private banks								
Federal Bank	REDUCE	ADD	330	13.0	16.0	6.0	20.0	**360**
J&K Bank	BUY	ADD	850	12.8	16.5	6.0	20.0	**965**
Banking business	BUY	ADD	740					**830**
New private banks								
Axis Bank	ADD	ADD	850	12.5	20.0	7.0	20.0	**930**
CBOP	ADD	REDUCE	45	12.5	20.0	7.0	0.0	**55**
HDFC Bank	REDUCE	REDUCE	1,250	11.8	20.0	7.0	20.0	**1,470**
ICICI Bank	ADD	ADD	1,200	12.5	16.0	7.0	25.0	**1,400**
Banking business	ADD	ADD	750					900

Source: Kotak Institutional Equities estimates.

Exhibit 2: Incremental credit deposit ratio shows a marginal improvement in November

Incremental credit to deposit with month of March as the base in each year(%)

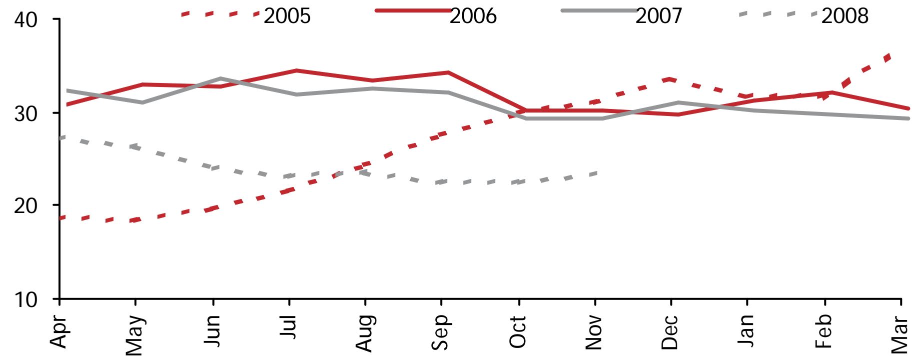


Note: Credit data in FY2005 impacted due to IDBI-IDBI Bank merger.

Source: RBI.

Exhibit 3: Loan growth has come off in FY2008, but still remains healthy

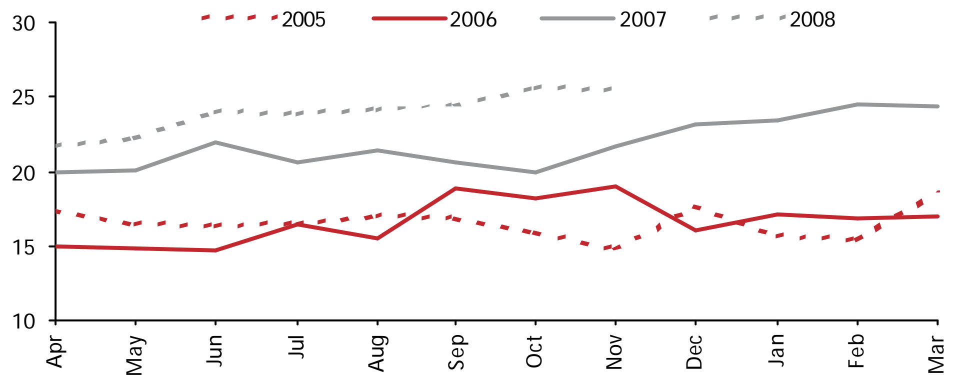
yoy growth in advances (%)



Note: Credit data in FY2005 impacted due to IDBI-IDBI Bank merger.
Source: RBI.

Exhibit 4: Deposit growth has been strong but has reduced marginally in November 2007

yoy growth in deposits (%)



Source: RBI.

Exhibit 5: Most banking stocks have out performed the market in the recent past

Stock price performance—absolute and relative (%)

	Price		Change in price (%)					Relative performance to sensex (%)					52 week	52 week	% change
	11-Dec-07	Rating	1 mth	3 mth	6 mth	12 mth	Ytd	1 mth	3 mth	6 mth	12 mth	Ytd	high	low	from high
Public banks															
Andhra Bank	106	BUY	17.8	14.0	28.1	25.7	22.4	9.7	(12.7)	(11.1)	(17.0)	(16.8)	111	70	(4.1)
Bank of Baroda	399	ADD	9.2	44.2	53.7	66.7	66.2	1.7	10.5	6.7	10.1	12.9	411	189	(3.1)
Canara Bank	317	SELL	18.3	24.5	31.9	13.5	14.7	10.2	(4.7)	(8.4)	(25.0)	(22.1)	318	174	(0.4)
Corporation Bank	446	BUY	5.0	31.1	49.0	35.1	28.8	(2.2)	0.4	3.4	(10.8)	(12.5)	490	212	(9.0)
Indian Bank	219	SELL	39.2	42.6	80.7	NA	NA	29.7	9.3	25.4	NA	NA	223	77	(2.0)
Indian Overseas Bank	185	ADD	32.7	34.1	65.6	67.2	67.4	23.7	2.7	14.9	10.4	13.7	199	89	(6.9)
Oriental Bank of Commerce	283	REDUCE	21.1	22.9	32.9	20.2	24.9	12.8	(5.8)	(7.7)	(20.6)	(15.1)	291	157	(2.8)
Punjab National Bank	667	BUY	26.1	35.7	31.7	31.2	31.6	17.5	4.0	(8.6)	(13.4)	(10.6)	675	400	(1.1)
SBI	2,446	ADD	13.1	50.8	82.6	96.8	96.3	5.4	15.5	26.7	30.0	33.4	2,475	845	(1.2)
Union Bank of India	207	BUY	14.8	40.8	74.7	72.4	69.0	6.9	7.8	21.3	13.8	14.8	213	84	(2.6)
Old private banks															
Federal Bank	328	ADD	(3.8)	20.7	57.4	104.8	96.9	(10.4)	(7.5)	9.2	35.2	33.8	395	144	(16.9)
J&K Bank	874	ADD	17.5	27.2	31.6	62.4	41.0	9.5	(2.6)	(8.7)	7.2	(4.2)	910	521	(4.0)
New private banks															
Axis Bank	940	ADD	2.7	45.3	66.4	111.8	100.3	(4.3)	11.3	15.5	39.9	36.1	1,025	399	(8.3)
CBOP	59	REDUCE	38.8	46.4	50.0	98.3	89.6	29.3	12.2	4.1	31.0	28.8	63	27	(7.0)
HDFC Bank	1,775	REDUCE	15.4	49.4	61.5	71.6	65.9	7.5	14.5	12.1	13.3	12.7	1,799	890	(1.4)
ICICI Bank	1,316	ADD	15.1	46.0	45.9	60.6	47.8	7.3	11.9	1.3	6.1	0.4	1,348	776	(2.4)

Source: Bloomberg, Kotak Institutional Equities estimates.

Exhibit 6: Reflected in the higher PBR and PER multiples for banks

Valuations of key financial companies, March fiscal year-ends

		Traget price	Price (Rs)	Market cap.	EPS (Rs)			PER (X)			ABVPS (Rs)			APBR (X)			RoE (%)			Dividend Yield (%)		
	Reco.	(Rs)	(Rs)	US $bn	2007	2008E	2009E	2007	2008E	2009E	2007	2008E	2009E	2007	2008E	2009E	2007	2008E	2009E	2007	2008E	2009E
Public banks																						
Andhra Bank	BUY	120	106	1.3	11.1	12.6	13.5	9.6	8.4	7.9	62	70	77	1.7	1.5	1.4	17.8	18.2	17.6	3.6	4.1	4.4
BoB	ADD	375	399	3.7	28.1	35.3	38.9	14.2	11.3	10.3	213	231	261	1.9	1.7	1.5	12.4	14.5	14.7	1.7	1.9	2.1
Canara Bank	SELL	250	317	3.3	34.7	33.1	28.7	9.1	9.6	11.0	173	206	232	1.8	1.5	1.4	16.3	12.8	10.5	1.9	2.1	2.2
Corporation Bank	BUY	470	446	1.6	37.4	44.7	49.2	11.9	10.0	9.1	244	271	305	1.8	1.6	1.5	15.0	16.3	16.3	2.0	2.4	2.8
Indian Bank	SELL	135	219	2.4	16.8	22.5	25.3	13.0	9.7	8.6	70	84	102	3.1	2.6	2.2	26.4	29.6	26.2	1.4	2.8	2.9
IOB	ADD	150	185	2.6	18.5	22.2	23.2	10.0	8.4	8.0	63	77	95	3.0	2.4	2.0	28.1	28.0	24.6	1.9	2.1	2.3
OBC	REDUCE	240	283	1.8	33.0	32.4	34.0	8.6	8.7	8.3	188	205	232	1.5	1.4	1.2	10.9	9.9	10.0	1.7	1.6	1.7
PNB	BUY	620	667	5.3	48.8	56.7	57.9	13.7	11.8	11.5	289	337	402	2.3	2.0	1.7	15.5	16.0	14.3	1.9	1.1	1.1
SBI	ADD	2,000	2,425	32.7	86.3	114.7	107.5	28.3	21.3	22.8	503	562	665	4.9	4.4	3.7	15.4	18.7	16.0	1.9	1.1	1.1
SBI incl. banking sub.	ADD	1,675	2,121	28.3	114.9	149.6	147.5	18.5	14.2	14.4	664	760	896	3.2	2.8	2.4	15.5	18.2	16.0	0.6	0.7	0.7
SBI standalone	ADD	1,308	1,754	23.4	74.9	106.1	98.0	23.4	16.5	17.9	454	513	616	3.9	3.4	2.8	14.6	18.8	15.7			
Union Bank	BUY	230	207	2.7	16.7	21.7	26.4	12.4	9.5	7.8	82	107	126	2.5	1.9	1.6	19.2	21.3	21.9	1.7	2.3	2.8
Old private banks																						
Federal Bank	ADD	330	328	1.4	34.2	40.2	33.0	9.6	8.2	9.9	161	228	253	2.0	1.4	1.3	21.2	15.5	13.5	1.2	1.5	2.0
J&K Bank	ADD	850	874	1.1	56.6	66.0	71.3	15.4	13.2	12.3	371	425	487	2.4	2.1	1.8	14.4	15.0	14.5	1.3	1.5	1.6
New private banks																						
Axis Bank	ADD	850	940	8.5	23.4	32.3	41.3	40.2	29.1	22.7	106	239	276	8.8	3.9	3.4	21.0	17.6	15.7	0.6	0.7	0.9
Centurion Bank	REDUCE	45	59	2.8	0.8	1.0	1.5	69.2	56.7	39.5	9	11	12	6.7	5.3	4.7	11.5	9.9	12.8	0.0	0.0	0.0
HDFC Bank	REDUCE	1,250	1,775	15.9	35.7	47.4	60.5	49.7	37.4	29.3	201	335	381	8.8	5.3	4.7	19.5	17.9	16.9	0.4	0.5	0.7
ICICI Bank	ADD	1,200	1,316	36.6	34.6	35.7	47.3	38.0	36.8	27.8	270	426	459	4.9	3.1	2.9	13.4	10.4	10.7	0.8	0.7	0.9
ICICI standalone	ADD	653	917	25.5	29.6	31.0	42.4	31.0	29.6	21.6	225	385	414	4.1	2.4	2.2	13.4	10.2	10.6			

Source: Bloomberg, Companies, Kotak Institutional Equities estimates.

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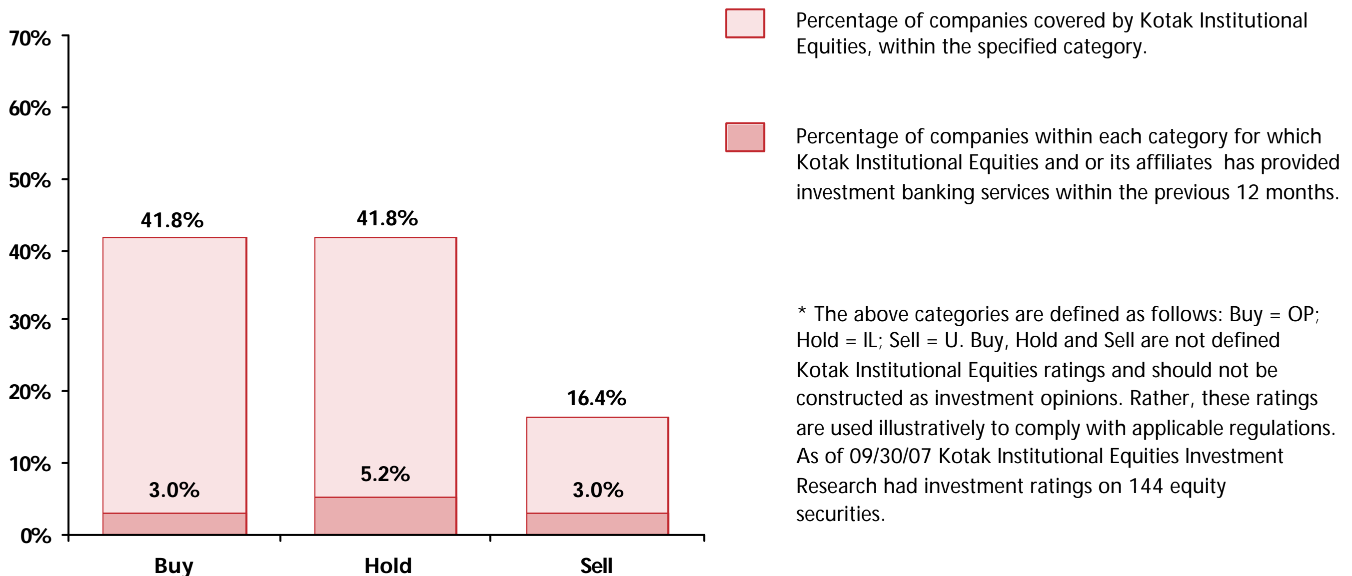

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Source: Kotak Institutional Equities. As of September 30, 2007

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