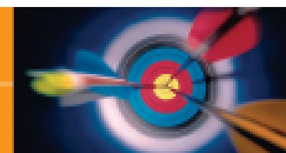
# investor's eye



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## Take Five

| Scrip | Reco Date | Reco Price | CMP | Target |
|---|---|---|---|---|
| ACC | 10-Aug-04 | 260 | **946** | 1,250 |
| Alphageo India | 29-Nov-06 | 150 | **208** | 270 |
| BHEL | 11-Nov-05 | 1,203 | **2,259** | 2,650 |
| HCL Tech | 30-Dec-03 | 206 | **664** | 820 |
| ITC | 12-Aug-04 | 69 | **170** | 220 |

## Pulse Track

### Interest on CRR to be positive for the sector

The Reserve Bank of India (RBI) has decided to pay interest on cash reserve ratio (CRR) balances with retrospective effect from June 24, 2006, when it had announced its decision to discontinue such payments. Currently banks do not receive any interest on their CRR balances.

The RBI has announced a graded payment of interest on the CRR balances maintained during a stipulated period. Banks will receive interest as mentioned in the table below for the corresponding period on the CRR balance with the RBI, over and above the minimum statutory requirement of a 3% CRR. The interest payment on the CRR balances comes as a reprieve for banks and will be marginally earnings accretive.

| Period for FY07 | CRR interest @ |
|---|---|
| 24-Jun-06 to 8-Dec-06 | 3.5% |
| 9-Dec-06 to 16-Feb-07 | 2.0% |
| 17-Feb-07 to 31-Mar-07* | 1.0% |

and beyond till further notice

### Impact on profits

The announcement will definitely help the profitability of banks with margins expected to improve by three to four basis points on an annualised basis for FY2007 and by one to two basis points in FY2008. We have also provided a table below to show the positive impact of the CRR interest payment on banks' FY2007 and FY2008 profits. Our analysis shows that as a result of this move, profits of the banks under our coverage would improve by 1.7% to 2.8% in FY2007 and by 1.3% to 1.8% in FY2008.

Banks are expected to receive the entire interest in Q4FY2007 and the same should range between 5% and 12% of their Q4FY2007 expected earnings and improve their Q4FY2007 earnings sequentially. The move comes as a reprieve for the banks and provides stability to their Q4FY2007 earnings on the face of the recent regulatory announcements that created a lot of concern over banks' Q4FY2007 earnings.

Impact on banks' profits

| Bank | % of Q4FY07E PAT | % of FY07E PAT | % of FY08E PAT |
|---|---|---|---|
| Allahabad Bank | 10.9 | 2.1 | 1.5 |
| Andhra Bank | 6.8 | 1.8 | 1.4 |
| Bank of Baroda | 12.2 | 2.8 | 1.8 |
| Bank of India | 9.1 | 2.8 | 1.8 |
| Canara Bank | 7.4 | 2.6 | 1.7 |
| Corp Bank | 10.4 | 2.1 | 1.5 |
| PNB | 8.6 | 2.2 | 1.5 |
| SBI | 6.8 | 2.3 | 1.5 |
| UBI | 7.7 | 2.5 | 1.8 |
| HDFC Bank | 5.5 | 1.7 | 1.3 |
| ICICI Bank | 5.2 | 1.7 | 1.5 |
| UTI Bank | 7.1 | 2.2 | 1.8 |

*Bank stock performance:* Among the public sector banking heavyweights, State Bank of India gained 2.9% and Punjab National Bank was up 5.2% today. Among the private banks, ICICI Bank and HDFC Bank declined marginally. The Sensex closed 0.12% up at 13649 while the BSE Bankex was up 0.63% at 6802.



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# Railway Budget 2007-08

## Railway Budget Special

### Capex binge of Railways to continue

Railway minister Lalu Prasad Yadav continues to guide the Indian Railways (IR) on a profitable growth path. Announcing his fourth budget for the IR today, he indicated that the capital expenditure (capex) binge of IR would continue. In a move to boost IR's key revenue stream (ie freight), the minister also extended major concessions on the freight rate front. He also reduced the passenger fares in a bid to increase the passenger traffic. The other salient features of the Railway Budget 2007-08 are an impressive reduction in the operating cost of IR, significant policy shifts to turn around the loss-making businesses of the national carrier, continued freight rationalisation and an increase in the capex of IR to make the railways more competitive.

The major beneficiaries of these moves are likely to be Texmaco, Kalindee Rail Nirman Engineers (Kalindee Rail) and Stone India. A few days back, in our special note "Turnaround Express going strong", dated February 22, 2007, we had mentioned how we expected companies like Hind Rectifiers, Simplex Casting, Stone India and Texmaco to show a healthy growth in their earnings on the back of the growing capex of IR.

Besides these companies, oil refiners, cement, steel and iron ore companies would benefit from the railway budget due to the reduction announced in the freight rates, though the impact on earnings is expected to be marginal.

### The highlights of Railway Budget 2007-08 are as follows.

- *Freight rates unchanged:* There would be no increase in the freight rates; however, the freight on diesel and petrol has been brought down by 5%, while that on iron ore and limestone has been cut by 6%. Also, passenger fares will be cut across the board.

- *Announcement of some freight schemes:* The budget includes changes in certain freight schemes, namely Empty Flow Direction Freight Discount Scheme (a 30% discount vs a 20% for the incremental loading in the empty flow direction and a 40% discount on bagged consignments like cement, fertilisers and wheat), an incremental freight discount scheme for non-peak season (15% for all commodities except coal, coke and iron ore) and the announcement of a commodity-based freight policy (an exclusive package for cement to be announced on April 1).

- *Best ever operating ratio:* The operating ratio of IR is likely to be 78.7% for FY2006-07, which is the best ever for IR and one of the best in the world. This ratio helped IR to improve its cash surplus before dividends during the year, which stood at Rs20,000 crore.

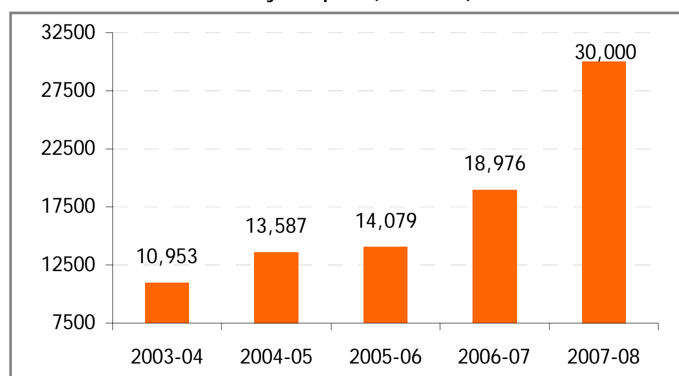
### Preparing for the 11th Five-Year Plan

FY2008 will be the first year of the 11th Five-Year Plan. Hence the railway minister has also made some key announcements regarding IR's targets for the 11th Plan. We believe that these announcements would ensure that the Turnaround Express stays on track and continues to provide good business for railway vendors, besides handing out some obvious benefits to the industry and passengers. Some of these announcements are as follows.

- A target of 1,100MMT freight loading and 840 crore passengers has been set for the terminal year of the 11th Plan.
- Construction of eastern and western dedicated freight corridors at a cost of Rs30,000 crore will commence from 2007-08 for completion during the 11th Plan.
- The container traffic to be increased to 100MMT by 2011-12.
- Most of the metre-gauge lines will be converted into broad-gauge lines by the end of this five-year plan.
- High-speed passenger corridors to be constructed to run trains at a speed of more than 300 kilometre per hour.
- The production of rolling stock will be doubled compared with the previous plan. The production of high-horse power and energy efficient locos to be increased.
- Manifold increase in investment in information technology to increase IR's earnings, ensure effective utilisation of its human and physical resources, and facilitate long-term policy decisions.

- *Containerisation:* The minister announced his vision to increase the container traffic to 100 million metric tonne (MMT) by 2011-12. Plans have also been announced to introduce triple-stack container trains on diesel routes and double-stack container trains on electrified routes.
- *Total capex plan of Rs30,000 crore for FY2007-08:* The total capex of IR for FY2007-08 is expected to be Rs30,000 crore, which includes outlays of Rs1,610 crore for new lines, Rs2,404 crore for gauge conversion, Rs300 crore for electrification and Rs722 crore for metropolitan transport projects. The outlay for the safety related plan heads includes Rs3,360 crore for track renewal, Rs597 crore for bridge works, Rs1,597 crore for signal and telecom works, Rs551 crore for the construction of road over/under bridges and Rs500 crore for road safety. The balance is expected to be used to acquire rolling stocks and modernise railway lines.
- *Freight corridor work to start in 2007-08:* The construction of the eastern and western dedicated freight corridors will start in 2007-08. These will be completed during the 11th Five-Year Plan at a cost of about Rs30,000 crore. About 50% of the traffic moves on the Golden Quadrilateral in spite of just 16% of rail network, leading it to be congested. Hence the IR is considering the feasibility of constructing East-West, East-South, North-South and South-South corridors. The freight corridors will improve not only the efficiency of freight transport but also the speed of passenger trains on regular routes.

**Growth in Indian Railways Capex (Rs crore)**




Source: Railway Budget Documents

## Key beneficiaries

**Beneficiaries of the capex measures:** Texmaco, Hind Rectifiers, Stone India and Kalindee Rail.

We expect Texmaco, Kalindee Rail, Stone India and Hind Rectifiers to be the key beneficiaries of the increased capex announced for procuring rolling stock. In fact, the rail minister has announced that it plans to double the production of the rolling stock in the 11th Plan compared with the previous plan. Such measures will improve the revenue visibility of the above companies.

Amongst the companies that we had not mentioned in the special report, we believe that Kernex Micro will be a key beneficiary too. The railway minister announced that the testing of the anti-collision device (ACD; a product that Kernex Micro specialises in) will be complete by March 2007. Given the fact that 2007-08 is the last year for incurring expenses under the Special Railway Safety Fund, we expect the demand for ACDs to increase substantially in the next year.

**Beneficiaries of freight measures:** Oil refiners, cement and steel companies

- *Oil refiners*: Oil refiners like Hindustan Petroleum Corporation and Bharat Petroleum Corporation are the direct beneficiaries of the 5% reduction in the freight rates. There could be a marginally negative impact of this reduction on Indian Oil Corporation though, given that the company's pipeline tariffs are pegged to rail freight. The impact of the measures announced in the budget on the earnings of these companies will be marginal.
- *Cement companies:* The rail budget is positive for the cement pack due to the announcement of the following measures.
  - Freight rate for limestone cut by 6%—neutral, as most of the cement plants are located near limestone mines.
  - The empty flow direction freight discount on cement has been increased to 40%—neutral, as cement generally is not transported in open wagons as required by the announcement.
  - To better address the needs of the customers transporting major commodities by rail, the railway minister has proposed a new commodity-based tariff policy, which is likely to be announced by April 1 with an exclusive package for cement.
- *Steel and Iron ore companies:* Steel and iron ore companies would be the beneficiaries of the 6% cut in the iron ore freight cost.

| Company Name | Supply | Price | TTM EPS | PER | Mcap to TTM Sales |
|---|---|---|---|---|---|
| Bharat Earth Movers | Rolling stock | 1130.0 | 51.9 | 21.8 | 1.7 |
| Hind Rectifiers | Equipment for rolling stock | 800.0 | 77.9 | 10.3 | 1.3 |
| Kalindee Rail | Construction | 176.3 | 7.4 | 23.9 | 1.3 |
| Stone India | Equipment for rolling stock | 158.6 | 14.6 | 10.9 | 1.5 |
| Texmaco | Rolling stock | 930.0 | 24.1 | 38.6 | 2.3 |
| Simplex Casting | Equipment for rolling stock | 46.4 | 7.5 | 6.2 | 0.2 |

# Information Technology

## Sector Update

## Policy tangles

The Indian information technology (IT) service companies have been demanding the extension of the prevailing tax exemptions on software technology park (STP) registered units under the Section 10A/10B of the Income Tax Act. As per the current guidelines, the tax exemptions for such units would cease to exist with effect from March 2009. But the industry associations are lobbying for the extension of the exemptions for another ten years in line with the proposed tax exemptions for the units located in the special economic zones (SEZs).

### Time to take a call

It is important that the government takes a stand on the issue. That's because the uncertainty related to the extension of tax exemptions is resulting in the delay of the expansion plans of many IT service and IT enabled service companies. On the one hand, the expansion at the existing STP registered units has been stalled due to the lack of clarity on tax exemptions. On the other hand, the SEZ policy has still not been formalised, leaving hardly any option for the mid-cap and small-sized companies that are unable to set up their own SEZ and would have to rely on leased-out facilities in any other third party SEZ.

### Gauging the impact of not extending exemptions

In case the tax exemptions on the STP units are not extended, the effective tax rate would increase for the Indian IT service companies in fiscal 2010. The extent of the increase in the tax rate would depend on the onsite-offshore revenue mix (since the onsite revenue is already taxed in the respective country), the percentage contribution from the taxable domestic business and the respective companies' ability to move incremental business to facilities located in SEZs.

Assuming that the front-line companies like Infosys Technologies and Tata Consultancy Services (TCS) are able to generate around 45-50% of their offshore revenues from SEZ units by FY2010 (by shifting incremental projects and business), the effective tax rate would increase by 500 to 850 basis points. This, in turn, would shave off the net profit margins of these companies by 100 to 250 basis points. This essentially means that the earnings growth in FY2010 would suffer a dent before getting normalised again in the following years.

| | Infosys | | TCS | |
|---|---|---|---|---|
| | FY2009 | FY2010 | FY2009 | FY2010 |
| Effective tax rate (%) | 12.0 | 20.2 | 14.0 | 21.0 |
| Net margin (%) | 24.9 | 22.6 | 21.3 | 19.4 |

### Impact could be more pronounced in mid-caps and product companies

The impact of not extending the tax exemptions under Section 10A/10B is likely to be more pronounced in the mid-cap and small-sized companies. That's because these companies would find it all the more difficult to attract quality talent at centres in SEZs as the SEZs are generally located outside the city limits and hence inconvenient for the employees. Moreover, the offshore contribution is relatively higher in case of the product-based companies that are eligible for tax exemptions currently.

### Conclusion

The extension of tax exemptions in the forthcoming Union Budget 2008 would be the best-case scenario for the IT industry. However, even if the government provides enough clarity on the issue it would be positive for the IT companies.

In case the exemptions are not extended, the impact of the same on the bottom line would be limited for the front-line companies. On the other hand, it would be a mixed bag for the mid-cap companies and the impact would depend on their revenue mix.

The author doesn't hold any investment in any of the companies mentioned in the article.

# Sharekhan Stock Ideas

## Evergreen

HDFC Bank
Infosys Technologies
Reliance Industries
Tata Consultancy Services

## Apple Green

Aditya Birla Nuvo
ACC
Apollo Tyres
Bajaj Auto
Balrampur Chini Mills
Bank of Baroda
Bank of India
Bharat Bijlee
Bharat Electronics
Bharat Heavy Electricals
Bharti Airtel
Canara Bank
Corporation Bank
Crompton Greaves
Elder Pharmaceuticals
Grasim Industries
Hindustan Lever
Hyderabad Industries
ICICI Bank
Indian Hotels Company
ITC
Mahindra & Mahindra
Marico
Maruti Udyog
Lupin
Nicholas Piramal India
Omax Autos
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
Alphageo India
Cadila Healthcare
Federal-Mogul Goetze (India)
KSB Pumps
Marksans Pharma
Navneet Publications (India)
New Delhi Television
Nucleus Software Exports
Orchid Chemicals & Pharmaceuticals
ORG Informatics
Tata Elxsi
Television Eighteen India
Thermax
UTI Bank

## Ugly Duckling

Ahmednagar Forgings
Ashok Leyland
BASF India
Ceat
Deepak Fertilisers & Petrochemicals Corporation
Fem Care Pharma
Genus Overseas Electronics
HCL Technologies
ICI India
India Cements
Indo Tech Transformers
Jaiprakash Associates
JM Financial
KEI Industries
NIIT Technologies
Punjab National Bank
Ratnamani Metals and Tubes
Sanghvi Movers
Saregama India
Selan Exploration Technology
South East Asia Marine Engineering & Construction
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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