kotak Institutional Equities

INDIA DAILY

April 02, 2007

EQUITY MARKETS

India	30-Mar	1-day	1-mo	3-mo
		Change, %		
Sensex	13,072	0.7	1.0	(5.2)
Nifty	3,822	0.6	2.0	(3.7)
Global/Regional indices				
Dow Jones	12,349	0.4	0.7	(0.9)
Nasdaq Composite	2,418	0.0	0.1	0.1
FTSE	6,302	(0.4)	2.1	1.3
Nikkie	17,288	0.1	(1.8)	0.4
Hang Seng	19,801	(0.1)	0.8	(0.8)
KOSPI	1,453	0.1	2.5	1.3

Value traded - India

	30-Mar		1-mo	3-mo
			Moving avg, Rs bn	
Cash (NSE+BSE)	135.4		118.9	119.1
Derivatives (NSE)	91.6		74.7	78.7
Deri. open interest	121.3		101.1	85.2

Forex/money market

	30-Mar	1-day	1-mo	3-mo
		Change, basis points		
Rs/US$	43.5	(21)	(73)	(72)
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	8.0	(2)	(2)	35

Net investment (US$mn)

	28-Mar		MTD	CYTD
FIIs	117		#N/A	40
MFs	(47)		#N/A	(303)

Top movers -3mo basis

Best performers	30-Mar	1-day	1-mo	3-mo
		Change, %		
SAIL	114	1.9	4.7	27.9
Punjab Tractors	305	1.0	(5.2)	22.2
Bharti Tele	763	0.3	6.2	21.4
Exide Indus	43	(0.6)	(8.3)	15.1
Britannia	1,251	2.4	1.3	14.6
Worst performers				
Acc	735	(0.0)	(18.4)	(32.3)
Tvs Motor	60	(0.9)	(2.9)	(31.7)
Century Tex	545	2.4	1.2	(26.3)
Hindalco	130	1.6	(6.7)	(25.2)
Grasim	2,091	1.8	(5.5)	(25.0)

Contents

Updates

News Roundup

Corporate

- Oil India Ltd (OIL) and Indian Oil Corporation Ltd (IOC) are set to float a separate entity for acquiring oil and gas assets abroad. The board of OIL has in-principle agreed to set up a special purpose vehicle (SPV) with IOC for overseas assets bidding. ***(BL)***
- ICICI Bank raised its floating reference rate (FRR) by 1% point to 12.75%. FRR is the benchmark rate to which home loans are linked. The largest private sector bank has also increased its benchmark advance rate (I-BAR), the rate to which all corporate loans are pegged, to 15.75% from 14.75%. ***(BS)***

Economic and political

- Fifty-two companies from nine States have offered to supply 1,061 mn litres of ethanol to the oil marketing companies (OMC) for 5% blending with petrol. The top suppliers are: Shree Renuka Sugars with 217 mn litres (21%), Bajaj Hindustan group 99 mn litres (10%) and Balrampur Chini Group 44 mn litres (5%).
- US crude futures eased on Monday, as the row between Iran and Britain reached a stalemate and as workers at a French oil hub ended a three-week-old strike. Oil closed 16 cents lower at $65.87 a barrel on Friday, the first decline after eight consecutive sessions of gains. Prices have risen more than 16 per cent since March 19 and rallied to a six-month closing high on Thursday. London's Brent crude was up 9 cents at $68.19. ***(ET)***

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

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

Chemicals

RELI.BO, Rs1368	
Rating	U
Sector coverage view	Neutral
Target Price (Rs)	1,270
52W High -Low (Rs)	1445 - 796
Market Cap (Rs bn)	1,906

Financials

March y/e	2006	2007E	2008E
Sales (Rs bn)	809.1	982.1	967.1
Net Profit (Rs bn)	88.0	106.8	102.0
EPS (Rs)	63.1	76.6	73.2
EPS gth	*22.8*	*21.4*	*(4.5)*
P/E (x)	21.7	17.9	18.7
EV/EBITDA (x)	13.7	10.5	11.9
Div yield (%)	0.7	0.8	0.9

Shareholding, December 2006

	Pattern	% of Portfolio	Over/(under) weight
Promoters	43.1	-	-
FIIs	23.5	6.6	0.5
MFs	2.3	4.0	(2.1)
UTI	-	-	(6.1)
LIC	4.5	7.1	1.0

Reliance Industries: Likely conversion of extant refinery to EOU to result in lower taxation

Sanjeev Prasad : sanjeev.prasad@kotak.com, +91-22-6634-1229

Gundeep Singh : gundeep.singh@kotak.com, +91-22-6634-1286

- **Refinery converted to EOU but development not confirmed by management**
- **Raised FY2008E and FY2009E EPS to reflect lower tax**
- **Not much impact on SOTP valuation; higher cash balance**

We have revised our FY2008E and FY2009E EPS estimates for Reliance to factor in (1) likely lower taxation arising from conversion of its extant refinery to an export-oriented unit (EOU), (2) lower chemical margins (chemical margins have come off strongly recently) (3) push-back of start of RPL refinery to April 1, 2009 from January 2009 previously, (4) incorporation of oil production from early FY2009 in KG-D6 block and (5) other minor changes. Our revised FY2008E and FY2009E EPS (consolidated for RPL) are Rs73.2 and Rs76 versus Rs63.1 and Rs74.8, respectively. There is not much change to our 12-month SOTP-based target price (Rs1,270 versus Rs1,225 previously) with higher cash balance (lower cash tax payment) being eroded by lower value for the chemical business. Key upside risks stem from higher-than-expected margins and new E&P discoveries.

Likely conversion of extant refinery to EOU; tax benefits on exports until FY2009. Reliance has not confirmed the conversion of its extant domestic tariff area (DTA) refinery to an EOU. However, press articles have reported the conversion with one of the articles even quotes the approving authority; so, we take this as confirmed. We note that extant Export Import Policy of India dealing with EOUs and the Income Tax Act allow conversion of a DTA unit to an EOU with related taxation benefits. Thus, Reliance can claim 100% tax deduction on exports (as long as it meets certain other criteria) for another two years; FY2009 is the last year for availing such benefits under Section 10B of the IT Act.

EPS up on lower tax but EBITDA down on lower chemical margins. The effective tax rate in our revised earnings model for FY2008E and FY2009E is 14.9% and 12.2% versus 27% and 25% previously. Lower tax rate explains our higher EPS estimates but we note that we have (1) cut chemical margins, (2) pushed back commissioning of RPL refinery to FY2010 from 4QFY09 previously, (3) assumed oil production in KG-D6 block from FY2010. Our FY2010E EPS is Rs141.3 versus Rs130 previously.

SOTP valuation facing serious limitations

We are increasingly inclined to move to earnings based-valuation for Reliance stock given (1) increasing visibility on earnings of new initiatives (E&P, RPL refinery) and (2) huge discrepancy in street valuation of certain assets (E&P with various reserves estimates of KG D-6 and other blocks). We note that Reliance's KG-D6 block would commence production in mid-FY2009 and start contributing to earnings from FY2009; thus, it becomes tricky to use SOTP based on FY2009E estimates. Similarly, RPL will start contributing to earnings from FY2010.

Exhibit 1 gives our new SOTP (based on FY2010E EPS discounted back two years) while Exhibit 2 is our previous SOTP updated for FY2009E estimates. The two methodologies give a similar result. In both these cases, we use 1,343 mn shares to compute the per share value (1,513 mn shares outstanding post conversion of 120 mn shares by mid-FY2009 equivalent to 120 mn warrants issued to the major shareholder and adjusted for 170 mn treasury shares). We have not factored in the impact of the proposed IPCL merger since Reliance will likely report on an 'as-is' basis until the merger receives all formal approvals (likely over the next six months).

12-month target price is Rs1,270
Valuation of Reliance stock on SOTP (Rs)

	FY2010E EPS (Rs)	P/E (X)	Valuation (Rs/share)	Comments
Chemicals, refining, E&P (a)	159	9	1,433	Consolidated FY2010E EPS including Reliance Petroleum
E&P (higher reserves in KG-DWN-98/3)			—	We model 17 tcf of gas production rom KG-DWN-98/3 block
E&P (NEC-25, CBM)			44	Based on KG D-6 reserves and valuation
Investments (b)			129	
IPCL and other investments			35	
Retailing			94	Likely large value creation longer-term but in a nascent stage presently
SEZ development			—	SEZs will require investment for the first few years
Valuation using FY2010E EPS			**1,605**	
12-month forward valuation			**1,269**	**12.5% discount rate; discounted two years back**

Notes:
(a) FY2010E EPS is adjusted for treasury shares or computed using 1.343 bn shares.
(b) We use DCF to value KG-basin reserves since cash flows will change over the years depending on the terms of the PSC.

Source: Kotak Institutional Equities estimates.

SOTP valuation of Reliance is Rs1,260 per share on FY2009 estimates
Sum-of-the-parts valuation of Reliance Industries, FY2008 basis (Rs)

	Valuation base (Rs bn)		Multiple (X)		EV	Value share
	Other	EBITDA	Muliple	EV/EBITDA	(Rs bn)	(Rs)
Chemicals		56		6.0	335	250
Refining & Marketing		77		5.5	426	317
Oil and gas—producing		17		4.0	67	50
Gas—developing (DCF-based) (a)	326	—	100%	—	326	243
Oil—KG-DWN-98/3 (b)	40	—	100%	—	40	30
Investments						
RPL (3.375 bn shares at CMP)	240	—	100%	—	240	178
Others (IPCL, others)	46	—	100%	—	46	35
Retailing	126	—	100%	—	126	94
SEZ development	—	—	100%	—	—	—
Total					**1,566**	**1,196**
PV of refining division's future sales tax incentives					2	2
Total value					**1,568**	**1,198**
Net debt (adjusted for capex of RPL and investment by Reliance in RPL) (d)					(73)	(54)
Implied equity value					**1,641**	**1,252**

Note:
(a) We value the KG D-6 gas find on DCF and offshore Orissa (NEC-25) and CBM discoveries based on KG D-6's valuation.
(b) 180 mn bbls of recoverable reserves based on gross OOIP of 0.5 bn bbls.
(c) Net debt reflects a standalone (without RPL) scenario; however, we consolidate for RPL otherwise as it a 75% subsidiary.
(d) We use 1.343 bn shares (excluding treasury shares) for our per share computation.

Source: Kotak Institutional Equities estimates.

Reliance Industries consolidated with Reliance Petroleum: Profit model, balance sheet, cash model 2002-2010E, March fiscal year-ends (Rs mn)

	2002	2003	2004	2005	2006	2007E	2008E	2009E	2010E
Profit model (Rs mn)									
Net sales	413,509	451,133	510,715	656,223	809,113	982,108	967,082	991,849	1,701,132
EBITDA	**71,379**	**75,808**	**91,148**	**123,820**	**139,991**	**178,521**	**164,297**	**177,848**	**327,965**
Other income	7,823	10,012	11,381	14,498	6,829	1,600	2,000	2,000	4,000
Interest	(18,251)	(15,552)	(14,347)	(14,687)	(8,770)	(10,693)	(4,967)	(2,793)	(1,343)
Depreciation & depletion	(28,161)	(28,371)	(32,470)	(37,235)	(34,009)	(39,879)	(41,626)	(51,402)	(66,649)
Pretax profits	32,790	41,897	55,711	86,397	104,041	129,549	119,705	125,652	263,973
Extraordinary items	11,497	7,845	7,300	4,290	3,000	3,121	2,962	2,795	2,619
Tax	(1,900)	(2,459)	(3,510)	(7,050)	(9,307)	(14,939)	(23,719)	(23,509)	(47,505)
Deferred taxation	(9,960)	(6,240)	(7,900)	(7,920)	(7,040)	(8,193)	5,417	7,826	3,988
Minority interest	—	—	—	—	—	—	—	—	(7,055)
Net profits	32,427	41,043	51,601	75,717	90,693	109,539	104,364	112,764	216,020
Adjusted Net profits	**21,423**	**33,586**	**44,708**	**71,760**	**87,954**	**106,769**	**101,975**	**110,481**	**213,867**
Earnings per share (Rs)	**15.3**	**24.1**	**32.0**	**51.4**	**63.1**	**76.6**	**73.2**	**76.0**	**141.3**
Balance sheet (Rs mn)									
Total equity	278,753	303,744	344,525	404,033	498,043	657,556	742,362	983,527	1,160,600
Deferred taxation liability	20,608	26,848	34,748	42,668	49,708	57,901	52,484	44,658	40,670
Minority interest	—	—	—	—	—	16,875	16,875	16,875	23,930
Total borrowings	189,285	197,583	209,447	187,846	218,656	114,918	192,136	109,845	27,739
Currrent liabilities	76,828	109,666	122,855	171,315	164,545	196,714	194,423	192,441	306,205
Total liabilities and equity	**565,474**	**637,842**	**711,574**	**805,863**	**930,952**	**1,043,964**	**1,198,280**	**1,347,347**	**1,559,144**
Cash	17,607	1,472	2,242	36,087	21,461	30,319	20,962	21,558	107,954
Current assets	176,900	227,809	218,159	248,438	224,283	260,341	259,087	260,487	381,766
Goodwill									
Total fixed assets	331,837	340,863	351,460	350,823	626,745	694,843	859,768	1,006,840	1,010,963
Investments	38,502	67,227	139,714	170,515	58,462	58,462	58,462	58,462	58,462
Total assets	**564,845**	**637,370**	**711,574**	**805,863**	**930,952**	**1,043,964**	**1,198,279**	**1,347,347**	**1,559,144**
Free cash flow (Rs mn)									
Operating cash flow, excl. working capita	63,528	67,072	83,301	107,002	119,520	155,155	133,215	147,177	278,130
Working capital	(5,688)	(17,614)	20,265	46,875	(32,188)	(3,889)	(1,037)	(3,381)	(7,515)
Capital expenditure	(16,189)	(37,043)	(43,191)	(52,440)	(94,273)	(108,564)	(199,459)	(191,888)	(67,166)
Investments	(25,724)	(34,204)	(68,430)	(48,192)	(32,364)	—	—	—	—
Other income	2,630	5,219	5,902	3,032	5,159	1,600	2,000	2,000	4,000
Free cash flow	**21,164**	**(25,180)**	**(8,204)**	**92,903**	**(2,413)**	**44,302**	**(65,281)**	**(46,093)**	**207,448**
Ratios (%)									
Debt/equity	63.2	59.8	55.2	42.1	39.9	16.1	24.2	10.7	2.3
Net debt/equity	57.3	59.3	54.6	34.0	36.0	11.8	21.5	8.6	(6.7)
RoAE	7.7	9.7	11.5	16.0	16.8	16.5	13.2	11.9	18.9
RoACE	**10.6**	**10.1**	**11.1**	**14.4**	**14.2**	**15.3**	**10.9**	**9.7**	**18.2**

Source: Kotak Institutional Equities estimates.

Reliance has high leverage to refining margins
Sensitivy of RIL's earnings to key variables

	Fiscal 2008E			Fiscal 2009E			Fiscal 2010E		
	Downside	Base case	Upside	Downside	Base case	Upside	Downside	Base case	Upside
Rupee-dollar exchange rate									
Rupee-dollar exchange rate	43.5	44.5	45.5	43.5	44.5	45.5	43.5	44.5	45.5
Net profits (Rs mn)	97,677	101,975	106,273	105,966	110,481	114,996	207,008	213,867	220,727
EPS (Rs)	70.1	73.2	76.3	72.9	76.0	79.1	136.8	141.3	145.9
% upside/(downside)	**(4.2)**		**4.2**	**(4.1)**		**4.1**	**(3.2)**		**3.2**
Chemical prices									
Change in prices (%)	(5.0)		5.0	(5.0)		5.0	(5.0)		5.0
Net profits (Rs mn)	98,299	101,975	105,649	107,073	110,481	113,887	210,843	213,867	216,891
EPS (Rs)	70.6	73.2	75.8	73.7	76.0	78.4	139.3	141.3	143.3
% upside/(downside)	**(3.6)**		**3.6**	**(3.1)**		**3.1**	**(1.4)**		**1.4**
Refining margins (US$/bbl)									
Margins (US$/bbl)	9.9	10.9	11.9	9.4	10.4	11.4	10.5	11.5	12.5
Net profits (Rs mn)	91,646	101,975	112,312	100,078	110,481	120,890	198,817	213,867	228,902
EPS (Rs)	65.8	73.2	80.6	68.9	76.0	83.2	131.4	141.3	151.3
% upside/(downside)	**(10.1)**		**10.1**	**(9.4)**		**9.4**	**(7.0)**		**7.0**

Source: Kotak Institutional Equities estimates.

Asia chemical margins, calendar year-ends (US$/tonne)

	Annual average margins					Quarterly average				Monthly average				Recent			
	2003	2004	2005	2006	2007	3Q06	4Q06	1Q07	1Q07 vs. 4Q06 (%)	Nov	Dec	Jan	Feb	Mar 2	Mar 9	Mar 16	Mar 23
Ethylene chain																	
HDPE – 1.015 x ethylene	158	28	147	88	34	27	152	34	(77)	173	127	(44)	113	220	288	342	382
LLDPE – 1.015 x ethylene	168	53	175	87	75	25	151	75	(50)	169	121	(8)	159	270	333	387	412
LDPE – 1.015 x ethylene	226	181	243	94	110	47	164	110	(33)	171	144	32	189	295	363	417	462
HDPE – naphtha	339	556	548	655	689	729	736	689	(6)	721	719	720	659	605	627	618	569
LLDPE – naphtha	350	582	577	654	730	727	734	730	(1)	717	713	756	705	655	672	663	599
LDPE – naphtha	408	710	644	660	765	748	748	765	2	718	736	796	735	680	702	693	649
Propylene chain																	
Propylene – naphtha	262	414	424	509	544	643	587	544	(7)	580	558	601	487	425	482	463	399
PP – 1.01 x propylene	154	142	154	125	146	70	123	146	18	115	141	124	167	184	129	129	149
PP – naphtha	421	564	587	645	701	726	722	701	(3)	706	710	736	665	620	622	603	559
Styrene chain																	
Benzene – naphtha	164	435	339	278	406	282	395	406	3	385	450	434	379	360	379	366	346
Styrene – 0.81 x benzene	203	142	131	139	129	139	179	129	(28)	182	147	108	149	160	162	171	179
– 0.29 x ethylene																	
Polystyrene – 0.98 styrene	116	124	125	90	156	89	101	156	55	117	112	169	144	138	144	154	127
PS – naphtha	517	786	670	649	830	690	793	830	5	793	821	873	787	735	745	736	679
Vinyl chain																	
EDC – (0.3 x ethylene)	171	186	99	11	86	(10)	81	86	6	83	69	67	105	124	131	147	160
PVC – 1.025 (0.235 x ethylene	251	258	281	249	168	261	206	168	(19)	183	166	135	200	237	269	302	313
+ 0.864 x EDC)																	
PVC – naphtha	350	492	326	250	292	294	295	292	(1)	261	237	310	274	220	242	253	209
Polyester/intermediates																	
PSF – 0.85 x PTA – 0.34 x MEG	296	157	247	240	342	190	327	342	4	289	345	336	348	—	—	—	387
PFY – 0.85 x PTA – 0.34 x MEG	374	398	398	391	562	352	501	562	12	454	520	556	568	—	—	—	597
PTA – 0.67 x PX	182	225	201	124	104	104	130	104	(20)	155	100	105	102	93	101	116	104
PX – naphtha	334	418	414	572	572	782	572	572	(0)	551	578	606	538	505	491	464	452
MEG – naphtha	386	564	384	270	304	303	287	304	6	300	286	327	280	250	252	238	199
MEG – 0.6 x ethylene	395	410	345	174	144	141	165	144	(13)	196	169	92	195	282	307	333	365

Source: Platts, compiled by Kotak Institutional Equities.

Telecom

VSNL.BO, Rs401	
Rating	OP
Sector coverage view	Neutral
Target Price (Rs)	560
52W High -Low (Rs)	515 - 300
Market Cap (Rs bn)	114.4

Financials

March y/e	2006	2007E	2008E
Sales (Rs bn)	37.8	41.5	48.4
Net Profit (Rs bn)	5.3	4.6	5.1
EPS (Rs)	18.6	16.2	18.1
EPS gth	*23.0*	*(13.0)*	*11.3*
P/E (x)	21.5	24.8	22.2
EV/EBITDA (x)	10.2	11.4	10.1
Div yield (%)	1.1	1.1	1.1

Shareholding, December 2006

	Pattern	% of Portfolio	Over/(under) weight
Promoters	76.2	-	-
FIIs	10.1	0.2	(0.2)
MFs	1.4	0.2	(0.3)
UTI	-	-	(0.4)
LIC	4.2	0.5	0.0

VSNL: Near term catalysts present a good buying opportunity

Sanjeev Prasad : sanjeev.prasad@kotak.com, +91-22-6634-1229
Kawaljeet Saluja : kawaljeet.saluja@kotak.com, +91-22-6634-1243

- **Flag listing will likely establish a valuation benchmark for TGN**
- **Real estate de-merger timing remains uncertain but some progress apparently**
- **Retain OP with SOTP-based target price of Rs560**

We cite two catalysts in VSNL, which will help bridge the gap between the stock price and our target price'(1) newspaper reports indicate that Reliance Communications (RCL) has appointed bankers for listing of Flag Telecom. This in our view would help provide a valuation benchmark for Tyco Global Network (TGN), which we value at the acquisition price (US$130 mn); (2) press articles report that VSNL may de-merge telecom business into a separate company, leaving it with only the real-estate business. This in our view may enable the company to unlock value of surplus real estate. We believe that the value of core business and investments at Rs368/ share provides a downside support to the stock at current levels. We retain our 12-month SOTP-based target price of Rs560. Key downside risks stem from weaker-than-expected profitability of the data segment and stronger-than-expected competition in the LD segment.

FLAG's listing will likely establish a valuation benchmark for TGN. We expect RCL's listing of FLAG to provide a valuation benchmark for TGN. TGN owns 65,000 kms of undersea cable exactly the same as that of FLAG. We value TGN at Rs5.7 bn (US$130 mn or Rs20/share of VSNL), the price paid by VSNL to acquire TGN. Although it is hard to compare the two assets directly in the absence of detailed financials, we expect a positive rub-off effect on VSNL if FLAG was to list at a 'good' valuation. Newspaper reports indicate a valuation figure of US$1.5-2 bn for FLAG.

Surplus real estate—newspaper reports indicate some progress on value unlocking. Press articles report that VSNL may de-merge its telecom business into a separate company and list it separately leaving VSNL with surplus real estate. The 'new structure' is different from the original 'proposal' (spin off of surplus land to a separate company) and seems more pragmatic as it may be a more tax-efficient method. We note that the government will own 51% in the land company and minority shareholders 49% (including 20% of the original shareholders who tendered their shares in the open-offer following VSNL's privatization). While there could be different structures, we assume that the government would be keen to realize the value of the surplus real estate.

Our sum-of-the-parts 12-month target price for VSNL is Rs560/share

	Estimated value		Value in SOTP		
	(Rs bn)	(Rs/share)	(Rs bn)	(Rs/share)	Comments
1. Core business					
Enterprise value (EV)	50	175	50	175	12-month forward DCF (discounting FY2007 onwards)
Net cash/(debt)	9	33	9	33	As of end-March 2007
Total	**59**	**208**	**59**	**208**	
2. Investments					
TATA Teleservices (TTSL)	32	112	32	112	Valuation based on US$5 bn equity value for TTSL
Tyco Global Network (TGN)	6	20	5.7	20	Valued at book value (100% taken in SOTP)
Teleglobe (TG)	8	28	8.1	28	Valued at book value (100% taken in SOTP)
SNO (South Africa)	0	0	0	0	No NPV ascribed (i.e. neither capex nor revenues modeled)
Total	**46**	**160**	**46**	**160**	
3. Others					
Surplus real estate	69	242	55	194	80% of estimated market value of surplus land
Total	**69**	**242**	**55**	**194**	
Grand total [1]+[2]+[3]	**174**	**611**	**160**	$\boxed{\textbf{563}}$	**12-month forward target price is Rs560**

Source: Kotak Institutional Equities estimates.

TGN's capacity is higher than FLAG's

Details of submarine cable capacity of Indian companies and major cable systems into and from India

Company	Cable	Capacity (Gbps)	Lit (Gbps)	Coverage	Landing station	Length (Route km)
Videsh Sanchar Nigam Ltd. (VSNL)						
	SEA-ME-WE2	1,100		13 countries (FRA - SGP)	Mumbai	18,000
	SEA-ME-WE3	505		33 countries (GER-JPN-AUS)	Mumbai, Kochi	39,000
	SAFE/WASC/SAT-3	250		Europe-Africa-SE Asia	Kochi	28,800
	Fujairah Analog Cable			India-Middle East	Mumbai	
	SEA-ME-WE4	1,280		14 countries		20,000
	Tata Indicom Cable (TIC)	5,120		India-Singapore	Chennai	3,175
	TGN					60,000
	Trans-Pacific	7,680				
	Trans-Atlantic	2,560				
	Western Europe	3,840				
	Northern Europe Ring	640				
Reliance Communications						
	FLAG			28 countries (US East Coast-Europe-ME-India-SE Asia-Japan)		52,000
	Atlantic 1	2,400	320			27,000
	Europe-Asia	80				12,800
	North Asia Loop	2,880	160			11,000
	FLAG NGN System 1			Asia (India-SE Asia)		
	FLAG NGN System 2			Africa		
	FLAG NGN System 3			Mediterranenean		
	FLAG NGN System 4			Trans-Pacific (US West coast-Japan-China-HK)		
	FALCON	2,560	90	12 countries (N Africa-Europe-Gulf-Asia)		11,589
Bharti Airtel						
	i2i	8,400		India - Singapore	Chennai	3,200

Source: Companies, compiled by Kotak Institutional Equities estimates.

We estimate value of surplus land at Rs194/share of VSNL

Derivation of value of surplus land held by VSNL

			Estimated value	
Location	**Acres**	**(000 sq ft)**	**(Rs/sq ft)**	**(Rs mn)**
Delhi—Greater Kailash	70	3,049	17,500	53,361
Delhi—Chattarpur	58	2,526	3,000	7,579
Pune—Dighi	524	22,826	300	6,848
Kolkata—Halisahar	35	1,533	250	383
Chennai—Adams Rd				
Chennai—Padinallur	86	3,744	250	936
Total	**773**	**33,678**		**69,107**
Taxes payable (Rs mn)				—
Net value recovered				69,107
Net value per VSNL share (Rs/share)				**242**
Value added to our target price—80%				**194**

Source: VSNL open offer document, Kotak Institutional Equities estimates.

Energy

Sector coverage view	Attractive

		Price, Rs	
Company	**Rating**	**30-Mar**	**Target**
IOC	IL	400	450
BPCL	OP	302	400
HPCL	OP	247	335

BPCL, HPCL, IOCL: Issue of oil bonds of Rs50 bn for 4QFY07 is a positive for earnings and sentiment

Sanjeev Prasad : sanjeev.prasad@kotak.com, +91-22-6634-1229
Gundeep Singh : gundeep.singh@kotak.com, +91-22-6634-1286

- **Government to give Rs49.7 bn of oil bonds in 4QFY07; Rs241 bn total for FY2007**
- **Fine-tuned estimates and gained more confidence in earnings estimates**
- **Valuations are attractive given certain amount of assurance on earnings**

We have updated our earnings model of BPCL, HPCL and IOCL to incorporate (1) issue of oil bonds of Rs49.7 bn for 4QFY07, (2) likely inventory gains in 4QFY07, which will reduce overall inventory losses for FY2007, and (3) moderately higher refining margins. In general, we have modestly raised FY2007, FY2008E and FY2009E EPS estimates. More important than the earnings revisions, we see the government support to the downstream oil companies as reassuring and the good FY2007 results encouraging in a high crude oil price environment (US$65.5/bbl Dated Brent average price in FY2007). We use a 30% discount to our 5X normalized EBITDA plus value of investments to set our 12-month target prices for BPCL (Rs400), HPCL (Rs335) and IOCL (Rs450). Key downside risks stem from higher-than-expected subsidy losses and weaker-than-expected refining margins.

Rs49.7 bn of oil bonds in 4QFY07 to result in solid profits for FY2007; consistent government action gives some assurance for the future also. The government will give Rs49.7 bn of oil bonds (8.4% coupon rate) to compensate for the marketing losses of 4QFY07, which will likely result in solid profits for FY2007 for the downstream oil companies despite a very difficult operating environment. The total amount of oil bonds for FY2007 including the latest (and presumably last) payment comes to Rs241.2 bn, moderately lower than the Rs283 bn estimated by the government in early FY2007 and our estimated Rs235 bn. We note that FY2007 (March 2006-February 2007 for a one-month lag) average crude price was US$65.5/bbl (Dated Brent); we expect moderately lower crude oil prices in FY2008 and FY2009. Thus, we see limited downside risk to the Indian oil companies' earnings in the ensuing years if the government follows the same approach as it has in FY2007. The government's support in FY2007 would suggest that government is committed to protect the bottom-line of the Indian downstream oil companies even if the approach may appear haphazard at times.

Earnings revisions—more confidence in earnings estimates now

BPCL—trading at 6.7X FY2008E EPS, 5.3% dividend yield. We have revised FY2007E, FY2008E and FY2009E EPS to Rs42.5, Rs45.1 and Rs49.2, respectively versus Rs39.7, Rs46.5 and Rs48.8, respectively, previously. The higher figure for FY2007E reflects lower inventory loss (nil versus Rs1 bn in 9MFY07) due to a moderate increase in product prices compared to end-3QFY07. The government will give oil bonds of Rs53.4 bn in FY2007E. The moderate reduction in FY2008E EPS reflects higher interest expense due to recent steep increase in interest rates; BPCL (like others) will have high debt due to cash flow issues. It cannot sell the oil bonds immediately to realize cash.

HPCL—trading at 6.3X FY2008E EPS, 6.1% dividend yield. We have revised FY2007E, FY2008E and FY2009E EPS to Rs37.3, Rs38.9 and Rs41.5, respectively versus Rs27.3, Rs34 and Rs43.6, respectively, previously. The higher figure for FY2007E reflects lower inventory loss (Rs2 bn versus Rs3 bn assumed previously) and higher oil bonds (Rs49.5 bn versus Rs48.3 bn assumed previously). The moderate yoy growth in FY2008E EPS reflects (1) higher crude throughput and better product yield from completion of ongoing refinery modernization and expansion projects at HPCL's Mumbai and Visakh refineries and (2) higher interest expense and depreciation due to commissioning of the aforementioned projects.

IOCL—trading at 8.3X FY2008E EPS, 4.0% dividend yield. We have revised FY2007E, FY2008E and FY2009E consolidated EPS to Rs44.1, Rs48.4 and Rs44.7, respectively versus Rs36.9, Rs49.2 and Rs49.1, respectively, previously. The higher figure for FY2007E reflects higher oil bonds of Rs138.3 bn (including that of IBP) versus Rs133.4 bn assumed previously by us and higher refining margins (US$4.3/bbl versus US$3.9/bbl previously). The yoy growth in FY2008E reflects higher crude throughput from full capacity of Panipat refinery (operational for part of the year in FY2007E).

Consolidated profit model, balance sheet, cash model of BPCL, March fiscal year-ends, 2004-2009E (Rs mn)

	2004	2005	2006	2007E	2008E	2009E
Profit model (Rs mn)						
Net sales	479,840	578,774	755,333	1,070,435	1,092,219	1,101,149
EBITDA	**38,686**	**26,231**	**9,407**	**30,240**	**32,788**	**34,740**
Other income	4,348	4,015	4,653	6,329	6,855	6,424
Interest	(1,447)	(1,748)	(2,474)	(4,986)	(5,581)	(4,702)
Depreciation	(6,754)	(7,130)	(7,680)	(8,397)	(9,381)	(9,493)
Pretax profits	34,833	21,368	3,906	23,186	24,680	26,969
Extraordinary items	(420)	810	176	—	—	—
Tax	(12,026)	(7,250)	(140)	(6,541)	(6,949)	(8,266)
Deferred taxation	(805)	(1,230)	(1,025)	(1,264)	(1,440)	(901)
Net profits	21,582	13,698	2,916	15,382	16,292	17,802
Net profits after minority interests	**19,086**	**11,334**	**2,916**	**15,382**	**16,292**	**17,802**
Earnings per share (Rs)	**64.6**	**37.2**	**7.6**	**42.5**	**45.1**	**49.2**
Balance sheet (Rs mn)						
Total equity	69,960	82,887	91,394	100,035	108,713	118,195
Deferred taxation liability	11,304	12,533	13,558	14,822	16,262	17,163
Total borrowings	32,701	46,589	83,736	90,786	70,536	55,816
Currrent liabilities	95,495	104,462	94,070	97,604	99,521	101,475
Total liabilities and equity	**209,459**	**246,472**	**282,758**	**303,247**	**295,031**	**292,649**
Cash	9,319	6,644	4,921	4,676	5,083	4,870
Current assets	97,729	130,393	128,208	118,308	109,687	110,146
Goodwill	—	—	—	—	—	—
Total fixed assets	88,484	98,542	110,855	122,574	127,572	139,943
Investments	13,927	10,893	38,774	57,689	52,689	37,689
Total assets	**209,459**	**246,472**	**282,758**	**303,247**	**295,031**	**292,648**
Free cash flow (Rs mn)						
Operating cash flow, excl. working capital	30,727	21,118	9,275	17,443	19,928	21,772
Working capital	1,025	(18,393)	1,577	13,435	10,538	1,495
Capital expenditure	(17,001)	(17,120)	(19,945)	(18,846)	(14,049)	(21,865)
Investments	1,278	2,992	(28,146)	(18,915)	5,000	15,000
Other income	1,985	2,445	1,785	6,329	6,855	6,424
Free cash flow	**18,015**	**(8,957)**	**(35,455)**	**(554)**	**28,272**	**22,826**
Ratios (%)						
Debt/equity	40.2	48.8	91.6	90.8	64.9	47.2
Net debt/equity	28.8	41.9	86.2	86.1	60.2	43.1
RoAE	28.8	14.4	3.3	14.0	13.6	13.7
RoACE	**32.6**	**18.1**	**4.1**	**10.3**	**10.8**	**11.4**
Key assumptions (standalone until FY2005)						
Crude throughput (mn tonnes)	8.8	9.1	17.2	19.5	19.8	20.0
Effective tariff protection (%)	7.2	4.8	2.9	1.4	1.2	1.3
Net refining margin (US$/bbl)	4.2	3.9	2.2	3.3	3.7	3.6
Sales volume (mn tonnes)	20.9	21.5	23.3	24.6	25.4	26.1
Marketing margin (Rs/tonne)	1,893	1,732	(671)	(1,142)	(440)	1,421
Subsidy under-recoveries (Rs mn)	(13,518)	(25,821)	(31,847)	(24,207)	(17,827)	(10,472)

Source: Kotak Institutional Equities estimates.

Earnings sensitivity of BPCL to refining margins, import duties and marketing margins (Rs mn)

	Fiscal 2008E			Fiscal 2009E			Fiscal 2010E		
	Downside	Base case	Upside	Downside	Base case	Upside	Downside	Base case	Upside
Refining margins									
Refining margins (US$/bbl)	2.7	3.7	4.7	2.6	3.6	4.6	1.9	2.9	3.9
Net profits (Rs mn)	11,886	16,292	20,697	13,416	17,802	22,188	11,587	16,066	20,546
EPS (Rs)	32.9	45.1	57.2	37.1	49.2	61.4	32.0	44.4	56.8
% upside/(downside)	**(27.0)**		**27.0**	**(24.6)**		**24.6**	**(27.9)**		**27.9**
Import tariffs									
Tariff protection	0.7	1.2	1.7	0.8	1.3	1.8	0.7	1.2	1.7
Net profits (Rs mn)	15,416	16,292	17,167	16,915	17,802	18,689	15,149	16,066	16,984
EPS (Rs)	42.6	45.1	47.5	46.8	49.2	51.7	41.9	44.4	47.0
% upside/(downside)	**(5.4)**		**5.4**	**(5.0)**		**5.0**	**(5.7)**		**5.7**
Marketing margins									
Auto fuels marketing margin (Rs/tonne)	(1,390)	(1,240)	(1,090)	1,294	1,444	1,594	1,395	1,545	1,695
Net profits (Rs mn)	15,432	16,292	17,151	16,463	17,802	19,141	14,679	16,066	17,454
EPS (Rs)	42.7	45.1	47.4	45.5	49.2	52.9	40.6	44.4	48.3
% upside/(downside)	**(5.3)**		**5.3**	**(7.5)**		**7.5**	**(8.6)**		**8.6**

Source: Kotak Institutional Equities estimates.

Profit model, balance sheet, cash model of HPCL, March fiscal year-ends, 2004-2009E (Rs mn)

	2004	2005	2006	2007E	2008E	2009E
Profit model (Rs mn)						
Net sales	512,001	597,020	708,609	897,657	915,617	919,809
EBITDA	31,858	20,511	8,056	21,764	27,361	30,563
Other income	6,583	5,833	4,707	3,587	3,020	3,016
Interest	(557)	(816)	(1,587)	(3,689)	(5,524)	(5,846)
Depreciation	(6,054)	(6,584)	(6,902)	(6,584)	(8,428)	(9,263)
Pretax profits	29,042	16,406	2,851	19,088	19,993	21,286
Extraordinary items	—	1,471	2,201	3,030	—	—
Tax	(10,225)	(5,897)	(898)	(7,271)	(5,982)	(5,766)
Deferred taxation	(540)	793	(97)	(174)	(814)	(1,469)
Prior period adjustment	762	—	—	—	—	—
Net profits	**19,039**	**12,773**	**4,056**	**14,673**	**13,197**	**14,051**
Earnings per share (Rs)	**56.2**	**34.8**	**6.6**	**37.3**	**38.9**	**41.5**
Balance sheet (Rs mn)						
Total equity	77,428	84,409	87,357	96,143	103,392	111,110
Deferred tax liability	14,541	13,748	13,844	14,019	14,833	16,302
Total borrowings	17,008	21,854	66,638	99,638	95,888	73,888
Currrent liabilities	76,551	69,887	79,549	83,347	88,178	89,873
Total liabilities and equity	**185,528**	**189,896**	**247,389**	**293,146**	**302,290**	**291,173**
Cash	1,971	2,016	426	272	425	243
Current assets	92,331	93,007	109,674	113,693	117,478	117,970
Total fixed assets	70,743	77,305	97,013	120,923	131,129	134,701
Investments	20,484	17,568	40,276	58,258	53,258	38,258
Total assets	**185,528**	**189,896**	**247,389**	**293,147**	**302,290**	**291,173**
Free cash flow (Rs mn)						
Operating cash flow, excl. working capital	29,062	15,977	10,126	11,757	14,641	18,951
Working capital changes	(13,410)	(3,614)	(5,351)	(221)	1,045	1,203
Capital expenditure	(8,895)	(12,849)	(25,298)	(28,417)	(17,419)	(12,835)
Investments	(342)	2,995	(22,884)	(17,982)	5,000	15,000
Other income	1,052	800	941	7,597	6,583	5,833
Free cash flow	**7,466**	**3,310**	**(42,466)**	**(27,266)**	**9,851**	**28,152**
Ratios (%)						
Debt/equity	18.5	22.3	65.8	90.4	81.1	58.0
Net debt/equity	16.4	20.2	65.4	90.2	80.7	57.8
RoAE	22.0	13.4	4.1	13.9	11.6	11.4
RoACE	**18.9**	**10.1**	**2.5**	**8.1**	**8.4**	**9.5**
Key assumptions						
Crude throughput (mn tonnes)	13.7	13.9	14.0	17.0	18.8	19.3
Effective tariff protection (%)	7.4	5.6	3.1	1.5	1.3	1.5
Net refining margin (US$/bbl)	4.4	4.5	3.9	4.1	4.1	4.0
Sales volume (mn tonnes)	20.1	20.6	21.3	22.0	22.5	23.1
Marketing margin (Rs/tonne)	1,861	1,688	(463)	(959)	(335)	1,422
Subsidy under-recoveries (Rs mn)	(12,870)	(26,708)	(29,671)	(23,008)	(17,618)	(12,921)

Source: Kotak Institutional Equities estimates.

Earnings sensitivity of HPCL to refining margins, import duties and marketing margins (Rs mn)

	Fiscal 2008E			Fiscal 2009E			Fiscal 2010E		
	Downside	**Base Case**	**Upside**	**Downside**	**Base Case**	**Upside**	**Downside**	**Base Case**	**Upside**
Refining margins									
Refining margins (US$/bbl)	3.1	4.1	5.1	3.0	4.0	5.0	2.2	3.2	4.2
Net profits (Rs mn)	9,004	13,197	17,391	9,822	14,051	18,280	9,936	14,160	18,384
EPS (Rs)	26.6	38.9	51.3	29.0	41.5	53.9	29.3	41.8	54.2
% upside/(downside)	**(31.8)**		**31.8**	**(30.1)**		**30.1**	**(29.8)**		**29.8**
Import tariffs									
Tariff protection	(0.2)	1.3	2.8	(0.0)	1.5	3.0	(0.3)	1.2	2.7
Net profits (Rs mn)	10,482	13,197	15,913	11,232	14,051	16,870	11,308	14,160	17,012
EPS (Rs)	30.9	38.9	46.9	33.1	41.5	49.8	33.4	41.8	50.2
% upside/(downside)	**(20.6)**		**20.6**	**(20.1)**		**20.1**	**(20.1)**		**20.1**
Marketing margins									
Transportation fuels margins (Rs/tonne)	(1,391)	(1,241)	(1,091)	1,295	1,445	1,595	1,396	1,546	1,696
Net profits (Rs mn)	12,492	13,197	13,903	12,952	14,051	15,150	13,020	14,160	15,300
EPS (Rs)	36.9	38.9	41.0	38.2	41.5	44.7	38.4	41.8	45.1
% upside/(downside)	**(5.3)**		**5.3**	**(7.8)**		**7.8**	**(8.1)**		**8.1**

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	2007E	2008E	2009E	2010E
Profit model (Rs mn)							
Net sales	1,173,450	1,379,018	1,732,849	2,147,235	2,221,773	2,261,782	2,327,888
EBITDA	**114,303**	**86,765**	**82,024**	**84,499**	**102,310**	**95,933**	**86,561**
Other income	17,565	16,138	25,714	24,262	25,074	21,738	19,321
Interest	(5,043)	(7,433)	(12,101)	(16,105)	(10,253)	(7,096)	(5,485)
Depreciation	(20,626)	(23,140)	(24,711)	(28,176)	(31,018)	(31,617)	(33,541)
Pretax profits	106,199	72,330	70,926	64,480	86,113	78,958	66,856
Extraordinary items	3,553	4,283	5,590	37,518	5,220	5,170	5,149
Tax	(25,966)	(13,658)	(19,975)	(10,091)	(26,072)	(25,852)	(19,769)
Deferred taxation	(5,157)	(2,335)	(1,282)	(5,964)	(2,028)	26	(1,943)
Net profits	79,052	59,475	55,509	85,944	63,233	58,302	50,294
Net profits after minority interests	**73,298**	**52,666**	**49,643**	**52,589**	**57,746**	**53,347**	**46,095**
Earnings per share (Rs)	**62.8**	**45.1**	**42.5**	**44.1**	**48.4**	**44.7**	**38.7**
Balance sheet (Rs mn)							
Total equity	233,386	271,302	317,977	385,943	421,710	453,656	480,973
Deferred tax liability	47,934	50,367	50,602	57,547	59,575	59,548	61,491
Total borrowings	146,147	197,809	292,395	274,190	201,604	142,861	98,781
Currrent liabilities	219,522	266,430	286,716	382,301	403,473	414,304	430,290
Total liabilities and equity	**646,988**	**785,907**	**947,691**	**1,099,981**	**1,086,362**	**1,070,369**	**1,071,536**
Cash	13,777	13,356	8,080	6,589	7,111	6,645	6,937
Current assets	278,550	368,158	413,904	515,513	535,204	542,862	557,365
Total fixed assets	320,647	370,003	383,717	408,987	415,154	431,970	458,341
Investments	34,013	34,391	141,990	168,892	128,892	88,892	48,892
Total assets	**646,988**	**785,907**	**947,691**	**1,099,981**	**1,086,361**	**1,070,369**	**1,071,536**
Free cash flow (Rs mn)							
Operating cash flow, excl. working capital	93,713	71,765	(10,334)	90,301	66,202	64,846	72,462
Working capital changes	1,710	(33,421)	(8,136)	(10,556)	(1,136)	4,442	(5,605)
Capital expenditure	(47,179)	(73,626)	(49,042)	(41,153)	(40,593)	(50,124)	(54,893)
Investments	(509)	(1,172)	(17,778)	(27,349)	40,000	40,115	40,000
Other Income	5,826	7,814	10,317	23,955	24,913	21,787	19,389
Free cash flow	**53,560**	**(28,641)**	**(74,973)**	**35,197**	**89,386**	**81,067**	**71,354**
Ratios (%)							
Debt/equity	52.0	61.5	79.3	61.8	41.9	27.8	18.2
Net debt/equity	47.1	57.3	77.1	60.3	40.4	26.5	16.9
RoAE	30.0	18.3	15.0	13.4	12.9	11.1	9.0
RoACE	**20.4**	**13.7**	**10.1**	**9.9**	**9.6**	**8.6**	**7.9**
Key assumptions (IOC standalone)							
Crude throughput (mn tonnes)	37.7	36.6	38.5	43.9	46.7	48.2	49.7
Effective tariff protection (%)	7.9	5.8	3.3	1.9	1.7	1.7	1.5
Net refining margin (US$/bbl)	5.4	6.2	4.8	4.3	4.2	4.0	3.5
Sales volume (mn tonnes)	47.1	48.2	50.4	52.5	54.2	56.1	58.1
Marketing margin (Rs/tonne)	2,092	1,982	26	(578)	91	1,839	1,754
Subsidy under-recoveries (Rs mn)	(28,078)	(64,309)	(95,361)	(52,147)	(39,274)	(33,421)	(29,152)

Source: Kotak Institutional Equities estimates.

Earnings sensitivity of IOC (standalone) to refining margins, import duties and marketing margins (Rs mn)

	Fiscal 2008E			Fiscal 2009E			Fiscal 2010E		
	Downside	**Base case**	**Upside**	**Downside**	**Base case**	**Upside**	**Downside**	**Base case**	**Upside**
Refining margins									
Refining margins (US$/bbl)	3.2	4.2	5.2	3.0	4.0	5.0	2.5	3.5	4.5
Net profits (Rs mn)	46,893	57,316	67,740	43,603	54,195	64,786	36,579	47,458	58,336
EPS (Rs)	39.3	48.1	56.8	36.6	45.5	54.3	30.7	39.8	48.9
% upside/(downside)	**(18.2)**		**18.2**	**(19.5)**		**19.5**	**(22.9)**		**22.9**
Import tariffs									
Tariff differential	1.2	1.7	2.2	1.2	1.7	2.2	1.0	1.5	2.0
Net profits (Rs mn)	55,109	57,316	59,524	51,894	54,195	56,495	45,063	47,458	49,852
EPS (Rs)	46.2	48.1	49.9	43.5	45.5	47.4	37.8	39.8	41.8
% upside/(downside)	**(3.9)**		**3.9**	**(4.2)**		**4.2**	**(5.0)**		**5.0**
Marketing margins									
Transportation fuels margins (Rs/tonne)	(1,382)	(1,232)	(1,082)	1,483	1,633	1,783	1,483	1,633	1,783
Net profits (Rs mn)	55,552	57,316	59,080	51,430	54,195	56,959	44,569	47,458	50,346
EPS (Rs)	46.6	48.1	49.5	43.1	45.5	47.8	37.4	39.8	42.2
% upside/(downside)	**(3.1)**		**3.1**	**(5.1)**		**5.1**	**(6.1)**		**6.1**

Source: Kotak Institutional Equities estimates.

Banking

Sector coverage view			Neutral

		Price, Rs	
Company	**Rating**	**30-Mar**	**Target**
SBI	OP	993	1,200
HDFC	IL	1,520	1,300
HDFC Bank	IL	949	1,000
ICICI Bank	OP	853	950
Corp Bk	U	289	340
PNB	OP	472	610
OBC	U	188	240
Canara Bk	OP	195	320
LIC Housing	U	138	160
UTI Bank	IL	490	435
IOB	OP	103	130
Shriram Transp	OP	119	155
SREI	OP	47	73
MMFSL	OP	233	280
Andhra	OP	76	115
IDFC	IL	84	85

Fear of further CRR/interest rate hikes could lead to fall in banking and finance stocks

Tabassum Inamdar : tabassum.inamdar@kotak.com, +91-22-6634-1252

Nischint Chawathe : nischint.chawathe@kotak.com, +91-22-6634-1588

Ramnath Venkateswaran : ramnath.venkateswaran@kotak.com, +91-22-6634-1240

- **RBI raises CRR, banks will likely increase PLR by 50bps**
- **Banking valuations are attractive, but stocks unlikely to perform till end of tightening period**
- **Sensitivity analysis shows some banks already factoring in significant NPLs**

In a surprise move the RBI hiked cash reserve ratio (CRR) by 50 bps (in two stages), reduced interest paid on CRR to 50bps from 100bps and increased repo rate (RBI lending rate) by 25 bps. We expect banks to follow this move with a 50bps hike in PLR. The close to 300-500 bps hike in lending rates over the last 15 months will likely impact: loan growth, spreads and asset quality. We have been assuming lower loan growth, stable to declining margins and higher provisions going forward. In this note we provide sensitivity analysis assuming much higher NPLs and higher cost of equity. Even adjusted for these not all bank stocks are overpriced. While valuations for most PSU banks remain low, and key banks continue to maintain focus on spreads and profitability, the concerns relating to RBI monetary policy will likely weigh down stocks performance till end of tightening. Given the RBI mood, our economist now fears another hike in CRR and we therefore find it difficult to recommend overweight position on banking sector and believe that in the short term investors should at best be neutral. Our preferred picks are PNB, IOB, BOB and Andhra Bank.

Banks will likely increase PLR: We believe that banks will follow the RBI recent move with atleast 50 bps hike. ICICI Bank, which has higher proportion of bulk deposit, has already raised rates by 100bps to protect spreads. If banks do not follow this move by increasing PLR or deposit cost, their earnings will likely be impacted by around 3 - 6% in FY2008 and FY2009 (Exhibit 1).

Loan growth already slowing in some sectors: Based on our discussions with some banks, we believe that the consistent increase in lending rates is now leading to a slowdown in retail lending business i.e housing, and auto loans. We expect the banking sector credit growth to taper off to around 19-20% in FY2008, down from 30% in early March 2007.

Spreads will likely remain stable to reduce marginally: In rising interest rate scenario, banks generally see an increase in margins as lending rates increase more than deposit rates. However, in India we have not seen a uniform trend. Banks with higher CASA, excess SLR and moderate credit growth have maintained or increased margins. We expect most banks to be focused on protecting margin, though the impact of deposit repricing may be felt with some lag over the next two years.

Asset quality may deteriorate, but not significantly: We believe that the increase in lending rates will likely lead to higher NPLs and therefore provisions compared to the last two years. However, we do not expect the asset quality issue to blow out as it did post the 1996 interest rate peak. The are several factors why we believe asset quality will remain manageable:

1. Economy unlikely to tumble and will likely grow at around 7-8%

2. We believe that the debt/equity ratios remain low compared to historical levels, given internal accruals and equity issuance. Based on capital line data base, net debt to equity ratio for 700 companies was down to around 0.5X from 1X in FY2006 (same set of companies).
3. Rise in property prices, will likely dissuade borrowers from defaulting.
4. Increase in wages likely more than historical levels, and increase in employment opportunities.
5. Risk based pricing, unlike pre December 2005, when banks were lending at low levels.

Amongst key sectors exposure to the real estate developers is most at risk. We believe that the banking sector exposure to this segment is around 4-6% of total loans.

Sensitivity analysis shows banks are already factoring in significant NPLs: We provide two set of sensitivity analysis across key banks on which we have an Outperform rating : (1) no change in earnings or BVPS estimate but increase in cost of equity by 50bps and (2) assuming higher NPLs, higher provisions and 100 bps increase in discount rate. We believe that if NPLs were to rise significantly banks will likely allow their net NPL ratio to rise to level of around 1.5-2% and not make 100% provisions against the gross NPL increase. This will be a fair assumption as on an aggregate basis the write-off ratio will be much below 100%. While this may be the case we believe that the market may penalize the banks by adjusting their BVPS and our analysis factors this in the ABVPS calculations. Based on this analysis BoB, Canara Bank and Andhra Bank trade at a 20% discount to their restated fair values, whereas ICICI Bank, SBI and PNB trade at restated fair values.

Exhibit 1: Assuming no increase in PLR or deposit cost, banks profits could be impacted by 3 - 6% due to 50 bps rise in CRR

	Average interest bearing liabilities (Rs mn)		Impact due to lower yield on incremental resources* (Rs mn)		Impact due to lower yield on on eligible CRR balances (Rs mn)		Net impact on PAT assuming no change in interest rates (%)	
	FY2008	**FY2009**	**FY2008**	**FY2009**	**FY2008**	**FY2009**	**FY2008**	**FY2009**
Andhra Bank	444,553	513,806	(211)	(244)	(67)	(77)	(3.1)	(3.4)
BOB	1,420,546	1,663,116	(675)	(790)	(213)	(249)	(4.7)	(5.0)
Canara Bank	1,630,223	1,888,755	(774)	(897)	(245)	(283)	(4.2)	(4.3)
Corporation Bank	508,635	610,932	(242)	(290)	(76)	(92)	(3.4)	(3.9)
IOB	732,646	858,564	(348)	(408)	(110)	(129)	(3.0)	(3.1)
OBC	688,538	798,392	(327)	(379)	(103)	(120)	(4.7)	(5.5)
PNB	1,584,209	1,811,940	(752)	(861)	(238)	(272)	(3.1)	(3.2)
SBI	5,052,548	5,804,526	(2,400)	(2,757)	(758)	(871)	(4.0)	(4.1)
HDFC Bank	967,043	1,294,585	(459)	(615)	(145)	(194)	(2.6)	(2.8)
ICICI Bank	3,729,036	4,775,851	(1,771)	(2,269)	(559)	(716)	(4.1)	(3.8)
UTI Bank	680,293	797,591	(323)	(379)	(102)	(120)	(3.5)	(3.4)

* Yield on incremental resources assumed at 10%

Source: Kotak Institutional Equities estimates.

Exhibit 2: Fair value estimates assuming 50bps increase in CoE

	Cost of equity (%)	Fair value estimate (Rs)	Cost of equity + 50 bps (%)	Fair value based on higher cost of equity (Rs)	Change in fair value estimate (%)
Public Banks					
Andhra Bank	12.75	115	13.25	100	(13.0)
BoB	12.50	310	13.00	285	(8.1)
Canara Bank	12.75	320	13.25	290	(9.4)
Corporation Bank	12.50	340	13.00	305	(10.4)
IOB	13.05	130	13.55	115	(11.5)
OBC	13.00	240	13.50	199	(17.0)
PNB	12.75	610	13.25	560	(8.2)
SBI	12.50	1,200	13.00	1,100	(8.3)
ICICI Bank	12.50	950	13.00	875	(7.9)

Source: Kotak Institutional Equities estimates.

Exhibit 3: Sensitivity analysis to fair value estimates assuming higher NPLs, higher NPL provisions and higher cost of equity

	Cost of equity (%)	Restated cost of equity (%)	Current target price (Rs)	Restated fair value (Rs)	Change in fair value estimate (%)	Upsides/downside on restated fair value (%)
Andhra Bank	12.8	13.8	115	91	(20)	20
BoB	12.5	13.5	310	257	(17)	19
Canara Bank	12.8	13.8	320	234	(27)	20
IOB	13.1	14.1	130	105	(19)	2
PNB	12.8	13.8	610	481	(21)	2
SBI	12.5	13.5	1,200	987	(18)	(1)
ICICI Bank	12.5	13.5	950	787	(17)	(8)
MMFSL	12.5	13.5	280.0	215.5	(23)	(8)
Shriram Transport	13.1	14.1	155.0	116.3	(25)	(2)
Srei Infrastructure finance	14.0	15.0	73.0	59.2	(19)	27

Source: Kotak Institutional Equities

Exhibit 4: Sensitivity analysis - change in EPS, BVPS and RoE assuming higher NPLs, and higher NPL provisions

	Current EPS estimate (Rs)		Restated ESP estimate assuming higher NPL provisions (Rs)		Change in EPS (%)		ABVPS (Rs)		Restated ABVPS assuming higher NPLs (Rs)		Current RoE estimate (%)		Restated RoE estimate (%)		PER on restated EPS (x)		APBVP on restated ABVPS (x)	
	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E
Andhra Bank	11.9	12.8	11.4	11.3	(3.7)	(12.3)	70	77	64	68	17.1	16.7	16.5	14.8	6.7	6.8	1.2	1.1
BoB	33.6	36.7	33.6	34.7	(0.0)	(5.4)	242	268	220	237	13.5	13.4	13.5	12.7	6.4	6.2	1.0	0.9
Canara Bank	38.2	43.3	34.0	31.4	(11.0)	(27.5)	215	244	183	197	18.2	17.9	16.4	13.5	5.7	6.2	1.1	1.0
IOB	17.9	20.6	17.2	16.5	(3.9)	(19.6)	79	96	69	81	22.5	21.6	21.7	17.9	6.0	6.2	1.5	1.3
PNB	65.8	73.5	56.4	64.9	(14.2)	(11.7)	387	429	325	435	17.9	17.3	15.6	15.7	8.4	7.3	1.5	1.1
SBI standalone	98.6	109.1	71.1	81.7	(27.8)	(25.2)	588	695	512	570	15.8	15.4	11.6	12.1	10.1	8.8	1.4	1.3
ICICI standalone	37.1	52.8	30.6	41.9	(17.6)	(20.7)	259	293	254	280	13.2	18.4	10.7	14.8	23.1	15.2	2.4	2.2

Source: Kotak Institutional Equities

Exhibit 5: Sensitivity analysis - increase in gross NPLs, and provisions

	Gross NPL estimates (Rs mn)			% increase yoy		Gross NPL assumed (%)			Net NPL assumed (%)			Current provision estimate (%)			Restated new provision estimate (%)		
	FY07E	FY08E	FY09E	FY08E	FY09E	FY07E	FY08E	FY09E	FY07E	FY08E	FY09E	FY08E	FY08E	FY09E	FY08E	FY08E	FY09E
Andhra Bank	4,806	10,579	16,107	120	52	1.6	2.9	3.8	0.4	1.5	1.7	0.4	0.5	0.8	0.4	0.6	1.1
BoB	27,255	43,224	58,355	59	35	3.1	4.1	4.8	0.5	1.3	1.5	0.5	0.8	0.9	0.5	0.8	1.0
Canara Bank	19,719	41,503	62,792	110	51	2.0	3.5	4.5	0.4	1.3	1.5	0.7	0.8	0.8	0.7	1.0	1.3
IOB	13,503	24,579	32,840	82	34	2.8	4.2	4.9	0.4	1.5	1.3	0.4	0.8	0.8	0.4	0.9	1.3
PNB	33,894	58,327	77,073	72	32	3.4	4.9	5.5	0.5	1.5	1.5	0.8	0.8	0.9	0.8	1.2	1.2
SBI standalone	120,303	196,603	254,627	63	30	3.5	4.8	5.5	1.4	2.0	1.9	0.6	0.6	0.8	0.6	1.2	1.3
ICICI standalone	51,554	104,893	177,096	103	69	2.4	3.6	4.9	1.0	1.3	1.6	1.3	1.2	1.3	1.3	1.5	1.7

Source: Kotak Institutional Equities

Property

Sector coverage view			Attractive

		Price, Rs	
Company	**Rating**	**30-Mar**	**Target**
MGesco	OP	568	1,100

Housing loan rates to increase as RBI raises CRR by 50 bps

Puneet Jain : puneet.j@kotak.com, +91-22-6634 1255

- **Rising interest will likely affect housing affordability in our view**
- **Increase in interest rates to have lesser impact on commercial, retail properties**

Housing loan rates have been on continuous uptrend over the last twelve months and have increased by 300+ basis points. Hardening interest rates for housing loans is likely to continue in the near term due to monetary tightening policy being undertaken by RBI. ICICI Bank has already increased rates by 100 bp in response to RBI's raising CRR by 50 bp on Friday. We believe that commercial and retail properties are less likely to be affected by increase in interest rate scenario since these segments are more dependent on GDP growth.

Rising interest will likely affect housing affordability in our view

Our affordability index for housing is as given in Exhibit 1. As seen in Exhibit affordability increased sharply in FY2000-04 period due to rising incomes and lower interest costs. However, post 2004 sharp increase in property rates and interest costs have led to decline in affordability. Interest rates in this period have increased by 350-400 bp which has resulted in EMI on a 15-year housing loan increasing by more than 20%. We believe that impact due to rising interest will be mitigated to certain extent by rising incomes. Also, consumers could take a longer tenure loan for e.g. EMI per Rs100,000 of 9.5% loan at Rs1,044 is quite similar to EMI per Rs100,000 11.5% loan. However, any further increase in property prices will likely impact affordability.

Increase in interest rates to have lesser impact on commercial, retail properties

Demand for commercial real estate is likely driven by GDP growth/Technology. Furthermore, retail real estate growth is more dependent on retailing than interest rates. Therefore impact of interest rate hikes is likely to be limited in the near term in these two real estate sub sectors

Rising interest rates has resulted in affordability going back to 2000 levels
Measurement of affordabilitiy of housing in India, March fiscal year-ends, 1999-2009e

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008E	2009E
Housing loan interest rates (%)	**14.5**	**13.9**	**12.8**	**12.1**	**10.4**	**8.9**	**8.0**	**8.5**	**9.5**	**11.5**	**11.5**
EMI per Rs100,000 on 15 yr loan (Rs)	1,366	1,325	1,252	1,207	1,099	1,008	956	985	1,044	1,168	1,168
Avg monthly household income (MHI) (for households with monthly income > Rs4,000)		8,923	9,145	9,375	10,881	11,714	11,659	12,991	14,126	15,103	15,951
Affordability assuming constant housing prices (EMI as % of MHI)		14.8	13.7	12.8	10.6	9.1	8.2	8.1	7.4	7.7	7.3
Capital price in Bandra (W), Mumbai		7,992	8,791	8,000	8,500	8,500	10,000	13,000	16,000	16,000	16,000
Affordability Index (assuming FY2000 as 100)		**100**	**101**	**86**	**76**	**65**	**69**	**88**	**105**	**110**	**104**

Source: RBI, Industry, Kotak Institutional Equities estimates.

Exhibit 2: Impact of a rise in interest rates on EMI/Rs100,000

	7.50%	8.50%	9.50%	10.50%	11.50%	12.50%
15 year loan (Rs)	927	985	1,044	1105	1,168	1233
% change	-	6.3	12.6	19.2	26.0	33.0
20 year loan (Rs)	806	868	932	998	1,066	1136
% change		7.7	15.6	23.8	32.3	40.9

Source: Kotak Institutional Equities.

Economy

Sector coverage view	N/A

India's interest rate outlook: RBI takes unnecessary risks with the India story

Indranil Sen Gupta : indranil.sengupta@kotak.com, +91-22-6634-1216

- **RBI hikes CRR by 50bps, repo rate by 25bps, cuts interest on CRR by 50bps**
- **Excessive monetary tightening a risk: CRR last increased by 150bps 20 years ago**
- **Futile against supply shocks; base effects, rabi crop to cut inflation in 1QFY08E**
- **Lending rates to increase by 100 bps - 50 bps earlier - in FY2008, impact growth**
- **Retain March 2007 10-year yield forecast at 7.5%; near-term 8.2% (from 8.1%)**
- **Rupee forecast at Rs44/USD FY2008E: weaker US Dollar vs forex intervention**

We are increasingly concerned about excessive monetary tightening against supply side inflation shocks. It is not, in our view, a coincidence that inflation has followed its own wayward course for all of RBI's hawkish posturing (Exhibit 1). Rising lending rates, on the other hand, increasingly put the India story at risk. This is the second time since the late 1980s that the cash reserve ratio—a blunt monetary instrument at the best of times - has been hiked 150 bps in a row: Governor Jalan got through even the 1998 South-Asian crisis with a 150bp hike. At the same time, it is only practical to factor in the possibility of another hike—the RBI hiked 200 bps of CRR during 1972 oil crisis in 70+ years - especially in the event of large-scale forex intervention given the growing imprudence of monetary policy. The India story's best bet: a scenario in which base effects pull down inflation—as we expect —in 1QFY08 allowing the Governor Reddy to claim 'victory'—never mind the long and variable lags of monetary policy! - and stop.

Third 50bp CRR hike in five months. The RBI hiked cash reserve ratio by 50bps of eligible demand and time liabilities to 6.5% in two equal stages effective April 14 and 28, 2007 to suck out Rs155 bn from the banking system.

This is buttressed by a 25bp hike in the LAF repo – cash for gilts - rate (to 7.75%).

Interest payable on eligible CRR (ie, the 3.5% beyond the statutory minimum 3%) is cut to 0.5% from the earlier 1%.

State Development Loans will qualify as eligible securities for LAF repos partly alleviating the impact of the CRR hike.

What happens now? Higher risks to growth. We have long highlighted that excessive monetary tightening is fast emerging as a risk to the India story.

- It is for this reason that we have consistently hoped that the RBI would not hike the cash reserve ratio—which raises the cost of borrowing - and instead operate through the Market Stabilization Scheme—which mops up liquidity without putting undue pressure on lending rates.
- It may be recalled that Governor Rangarajan's FY1995 100bp CRR hike created a credit crunch that killed the mid-1990s growth phase—despite a desperate 550bp CRR cut between November 1995-97.
- Unlike Rangarajan, who—Volcker-like—tamed double-digit inflation, the present regime is tilting at the windmills of supply-shock driven 6%+ inflation.

- We cannot believe that the RBI is not unaware of the dangerous path it has perhaps inadvertently—4-80% swings in call rates in a fortnight cannot be exactly planned! - embarked on by turning its back on every reformist measure it has itself propagated the last 15 years: narrowing of interest rate corridor (widened to 175bps), use of administrative measures like CRR (increased by 150 bps), strengthening of market-oriented policy (capping reverse repo operations under the LAF) etc.
- We expect the RBI to get off this unsustainable monetary policy mix of defending a contradictory coupling of repo rate hikes and forex intervention with CRR hikes if 1QFY08 inflation peak-off – which we expect – allows it to claim a victory of sorts.

What about interest rates? 100bp lending rate hike in FY08E. Lending rates will likely increase by 100bps – we had earlier expected 50bps – in FY2008E as the higher CRR requirement aggravates the credit gap.

- Exhibit 2 shows that the higher CRR – even assuming this is the last of the series - escalates our credit gap to a whopping Rs821bn/ US$18.7 bn, after the present CRR hike, even assuming 21% credit offtake (consistent with 8.3% real GDP growth rate/ 5% inflation).
- Even assuming a 1% SLR cut, the credit gap remains a large Rs514 bn / US$11.7 bn comparable with FY2007E's Rs419 bn.
- The bank loan market will clear at current lending rates at 19% credit offtake, which would pull down real GDP growth rate to about 8% levels (assuming retail loans slow down to 20%).
- We have long highlighted that the gap between the real lending rate – currently 7%—and the potential real GDP growth rate – 7.8% - is closing rapidly (Exhibit 3).

Why? Inflation expectations, UP polls, April liquidity, forex intervention. The RBI – and increasingly the government - appears to believe that a regular flow of monetary policy action is necessary to sustain 5% inflation expectations at a time of 6%+ WPI inflation even if it is driven by supply shocks.

- The RBI probably wants to keep a tight rein on liquidity – M3 is growing at 22% higher than the optimal 17.5% consistent with 5% inflation—so that supply shocks are not accommodated.
- The CRR hike is probably aimed at mopping up seasonal April liquidity: credit demand unwinds in the first quarter of the fiscal year.
- The CRR hike could signal that the RBI will likely intervene in the forex market to contain Rupee appreciation: the real effective exchange rate is likely past the 8% overvaluation benchmark at which the central bank has acted in the past.
- The government appears to want to be seen to be fighting inflation any which way before the critical UP polls, which begin April 7, 2007.

Was it necessary? No! supply shocks, inflation peak-off, MSS, government borrowing. The basic premise that monetary measures can contain fight supply shocks is—to say the least—open to question. It is not a coincidence – as we have constantly highlighted—that inflation has followed its own wayward path for all of the RBI's hawkish postures.

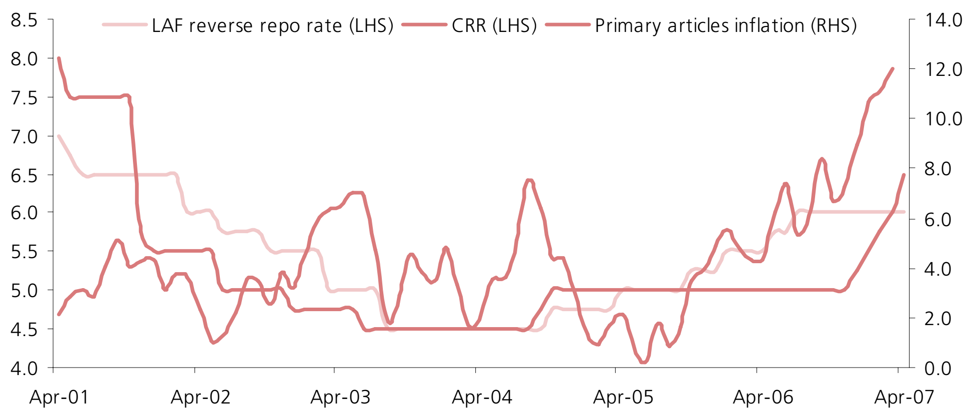
- The higher FY2007 M3 growth also has to be viewed in context of average 15.6% FY2006. It is surely wrong to caricature the medium-term relationship between money and inflation into a contemporaneous data point – to - data point.

- In any case, we expect inflation to peak off in 1QFY08 on the back of base effects such as the April 2006 oil price hike and 11% increase in metal prices in 1QFY07 (Exhibit 4).
- We had expected the RBI/government to front-load the government borrowing program to mop up April liquidity instead of using CRR which is a tax on the banking system.
- We had also expected the RBI to continue with the Market Stabilization Scheme to mop up liquidity injected by forex intervention.
- It also remains to be seen how much of the Rupee appreciation is because of forex flows and how much reflects last fortnight's cash crunch.

Monetary policy tightening will after all only attract larger capital flows as corporates raise external commercial borrowings playing interest rate differentials and put further pressure on the Rupee.

Exhibit 1: Monetary policy action futile against monsoon shocks

LAF reverse repo rate, primary articles inflation (%), cash reserve ratio (% of demand and time liabilities)



Source: Ministry of Industry.

Exhibit 2: CRR hikes escalate a persistent credit gap, likely keep lending rates firm

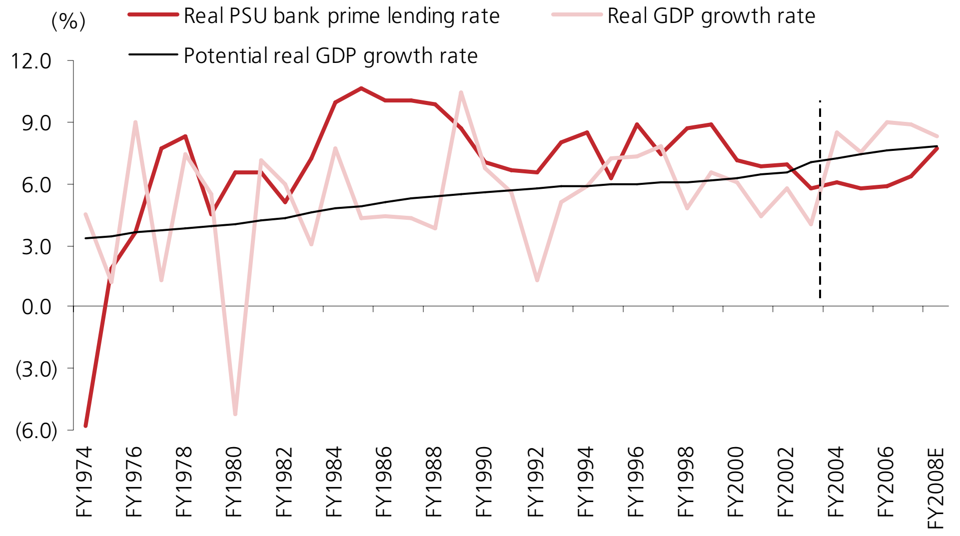
Sources and uses of bank funds (in Rsbn)

Key sources/uses	25% SLR FY2008E	24% SLR FY2008E
1. Deposits	3,907	3,907
2. Non-deposit sources	200	200
3. Primary issuances	150	150
4. Bank reserves	418	418
5. Investment in government securities	404	97
6. Net foreign assets	(100)	(100)
7. Resources available for interest rate-neutral credit offtake (1+2+3-4-5-6)	3,535	3,842
8. Credit offtake/demand	4,356	4,356
9. Credit gap (8-7)	821	514
Memo item		
1. Capital account	200	200
2. Other liabilities	262	262

Source: RBI, Kotak Institutional Equities.

Exhibit 3: But can end up hurting growth

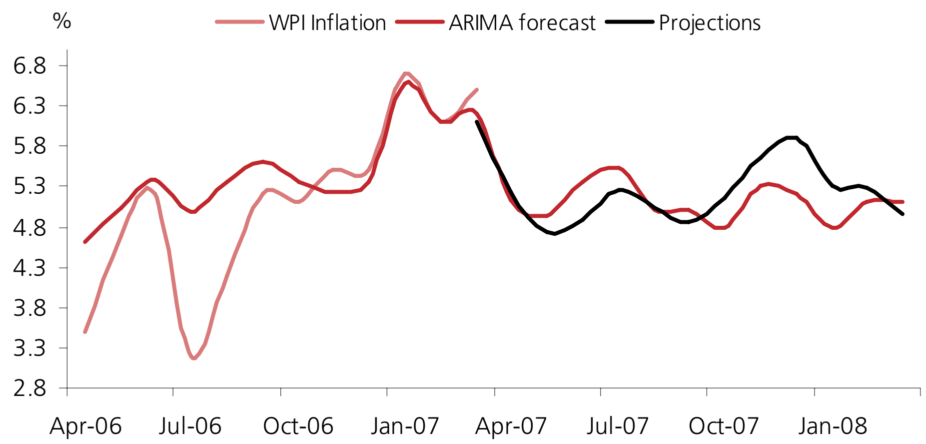
Real PSU bank prime lending rate, real GDP growth rate (%)



Source: CSO, RBI, Kotak Institutional Equities.

Exhibit 4: Inflation likely peaking off

WPI, WPI (ARIMA forecast) y-o-y %



Source: Ministry of Industry, Government of India.

Economy

Sector coverage view N/A

India's December 2006 External Debt: Growing interest rate differential, project finance gap

Indranil Sen Gupta : indranil.sengupta@kotak.com, +91-22-6634-1216

- **External debt at US$ 142.7 bn as at end-December 2006; 16.3% of GDP FY2007E**
- **Indicators of sustainability remain in control**
- **Interest rate differential, domestic project financing gap enlarging external debt**
- **70%+ FII equity investment /foreign exchange reserves**

India's external debt jumped 18.9% y-o-y to US$ 142.7 bn as at end-December 2006 (Exhibit 1). This was partly driven by an India Millennium Deposit effect which saw bullet redemption in December 2005 and returned by March 2007. Even more importantly, external commercial borrowings are rising as corporates arbitrage growing interest rate differential. This is also whetted by an emerging domestic project finance gap ' especially at 5+ year tenor. It must also be recalled that FII investments in equity account for about 70% of forex reserves on a mark-to-market basis. While the external debt numbers are still not worrying in themselves, it is increasingly necessary to monitor this space. Non-resident Indian (NRI) deposits and commercial borrowings account for half of external debt. The US Dollar (46.3% of total) and the Indian Rupee (19.3%) dominate the currency profile.

Exhibit 1: India's external debt

Debt in US$bn; ratios % of GDP.

Item	December 2006	September 2006	June 2006	March 2006
Multilateral	34.6	33.6	33.1	32.6
Bilateral	15.8	15.7	15.8	15.7
International Monetary Fund	0.0	0.0	0.0	0.0
Export Credit	6.0	5.6	5.5	5.4
Commercial borrowing	36.0	32.4	31.0	26.8
NRI deposits	38.4	36.6	35.7	35.1
Rupee debt *	2.0	1.9	1.9	2.0
Total long-term debt	132.6	125.9	123.1	117.7
Short-term debt	10.0	10.6	9.1	8.7
Gross Total	142.7	136.5	132.2	126.4
External debt ratio				15.8
External Debt servicing ratio				10.2

* Debt denominated in Rupees and payable in exports

Source: RBI.

Economy

Sector coverage view	N/A

India's April 2006 - February 2007 fiscal deficit: Well on track

Indranil Sen Gupta : indranil.sengupta@kotak.com, +91-22-6634-1216

- **Center's April 2006 - February 2007 gross fiscal deficit at 80.0 % of budget estimates**
- **Government well on track to FY2007E 3.7% of GDP fiscal deficit**
- **Substantial US$ 17.3 bn government surplus with the RBI.**

The Center's 11MFY07 gross fiscal deficit (GFD) improved to 80.0% of budget estimates from 90.5% last year (Exhibit 1). We now expect the Center to achieve the budget estimate of 3.8% of GDP set out in the Union Budget FY2007 in alignment with the Fiscal Responsibility and Budget Management Act, 2003 given higher economic growth. The Center continued to register a monetary surplus of Rs771 bn / US$17.3 bn with the RBI on March 23, 2007, largely reflecting Rs592/ US$13.3 bn parked by States in intermediate 14-day Treasury Bills.

Exhibit 1: A fisc on track
(% of budget estimates, April-February)

	FY06	FY07
1.Revenue receipts	77.2	81.3
Tax revenue	75.8	80.0
Non-tax revenue	82.5	86.8
2. Non-debt capital receipts	75.1	83.3
Recovery of loans	76.8	91.2
Other receipts	-67.0	0.9
3. Total receipts (1+2)	77.2	81.3
4. Non-plan expenditure	82.1	81.9
4.1 On revenue account	85.4	86.1
4.1.1of which: Interest payments	85.4	86.2
On capital account	54.6	49.8
of which: loans disbursed	44.3	77.7
5. Plan expenditure	78.1	78.7
5.1 On revenue account	78.3	79.4
On capital account	77.5	75.1
of which: loans disbursed	72.9	78.6
6. Total expenditure	81.0	81.0
7. Gross fiscal deficit (6-3)	90.5	80.0
8. Revenue deficit (4.1+5.1-1)	107.4	98.8
9. Primary deficit (7-4.1.1)	130.8	-67.7

Source: Government of India.

Economy

Sector coverage view	N/A

India's Apr-Dec 2006 balance of payments: On firm footing

Indranil Sen Gupta : indranil.sengupta@kotak.com, +91-22-6634-1216

- **Current account deficit US$11.8 bn; sustainable 1.2% of GDP FY07E, 1% FY08E**
- **Invisibles strong support, BPO scaling up: US slowdown to impact momentum**
- **Interest rate differential, domestic project financing gap enlarging ECBs**
- **Rising FDI; US$ 8 bn FY2008E FII inflow assuming market consolidation**
- **US$ 20 bn FY08E RBI forex intervention likely to ensure domestic liquidity**
- **Rupee forecast at Rs44/USD FY2008E: weaker US Dollar vs forex intervention**

India's current account deficit amounted to US$11.8 bn during 9MFY07, comparable with last year's US$9.5 bn. Invisibles, especially software services, continued to provide powerful support: BPO is the new kid on the BoP block. We forecast India's current account deficit at a reasonably comfortable 1.2% of GDP in FY2007 and 1% of GDP in FY2008, assuming that Dated Brent prices soften to US$60/bbl. Given sustained capital flows, this, in turn, implies that the RBI will likely able to buy up US$ 20 bn comfortably funding domestic liquidity in FY2008E – we estimate an additional US$9 bn requirement - and building up advance provisions for FY2009E liquidity – which will require US$28 bn at 7.8% real GDP growth rate. We expect the Rupee to settle at Rs44/USD by end-FY2008 assuming that the US Dollar settles at 1.34/Euro partly compensating the impact of the RBI's forex intervention (Exhibit 1).

Sustainable current account deficit. We have projected India's current account deficit at a sustainable 1.2% of FY07E GDP and 1% of FY08E GDP (Exhibit 2).

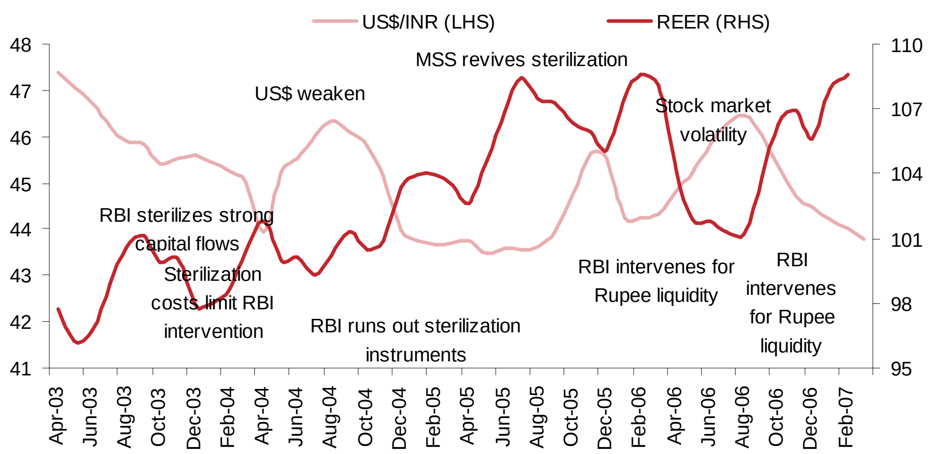
- This assumes that Dated Brent prices stabilize at US$ 60/bbl in FY2008E. A US$1 increase in oil prices impacts the current account deficit by US$500-600 mn.
- We have assumed a slowdown in exports (13.4% from 20% FY2007E) and invisibles (10% from 21% FY2007E) because of base effects and US slowdown.
- Non-oil merchandise imports are also forecast to moderate (16.8% from 30% FY2008E) on the back of a projected deceleration in real GDP (8.3% from 8.9% FY2007E)
- Non-DGCI&S – essentially defense – imports are taken at around US$10bn.
- The RBI's income on forex reserves are assumed at a whopping US$10 bn with the US federal funds rate projected to decline by 50 bps in 2HFY08.

Software services provide powerful support: BPO new kid on the BoP block. Invisibles will likely continue to be robust, notwithstanding some moderation on account of a likely US slowdown. Software services exports have been particularly strong this year (Exhibit 3). Besides, business services are beginning to scale up meaningfully (Exhibit 4).

ECBs dominate capital flows, FDI picking up, reduced reliance on FIIs. We expect the capital account to continue to post a surplus of US$39 bn in FY2008E somewhat lower than this year's US$43.5 bn. This, in turn, will continue to allow reserve accretion despite the current account deficit (Exhibit 5).

- External commercial borrowings (ECBs) will likely continue to be in the lead especially if our projected 100bp increase in domestic lending rates and a 50bp cut in the US federal funds rate materializes to encourage corporate arbitrage (Exhibit 6). Furthermore, an emerging domestic project finance gap at 5+ year tenor is also likely to encourage ECBs.
- Foreign direct investment is projected to expand to US$10 bn in FY2008E from US$ 8 bn in FY2007E (US$5.8 bn during 9MFY07 up from US$3.3 bn last year).
- We continue to project FII inflows at US$ 8 bn in alignment with our strategy thesis of consolidation in equity markets.

Exhibit 1: The Rupee faces a tug of war between RBI forex intervention and a weaker US Dollar



Source: RBI, x-rates.com

Exhibit 2: A reasonably robust balance of payments outlook

India's balance of payments (US$bn)

Item	FY2005	9MFY06	FY2006	9MFY07	FY2007E	FY2008E
Current Account	**-5.4**	**-9.5**	**-9.2**	**-11.8**	**(11.0)**	**(10.0)**
% of GDP	-0.4		-1.1		(1.2)	(1.0)
Trade balance	-36.6	-40.1	-51.8	-52.3	(63.0)	(68.0)
- Exports	82.2	74.6	105.5	91.3	126.0	144.0
- Imports	118.8	114.7	157.0	143.6	189.0	212.0
o/w Oil imports	29.8	31.5	43.9	43.8	55.0	56.0
Invisibles	31.2	30.6	42.7	40.5	52.0	58.0
o/w income from forex reserves	3.9		5.5		7.5	10.0
Capital Account	**31.5**	**7.7**	**24.2**	**28.0**	**43.5**	**39.0**
Foreign investment	12.1	11.5	17.2	11.0	16.0	18.0
- FDI	3.2	3.3	4.7	5.8	8.0	10.0
- FII+	8.9	8.2	12.5	5.2	8.0	8.0
Banking capital	3.9	1.8	1.4	1.1	6.0	6.0
- NRI deposits	3.0	1.1	2.8	3.2	5.0	3.5
Short term credit	3.8	1.7	1.7	1.3	3.0	3.0
ECBs	5.0	-1.2	2.7	9.1	12.5	10.0
Others	6.7	-6.1	1.2	5.5	6.0	2.0
Overall balance	**26.2**	**-1.8**	**15.1**	**16.2**	**32.5**	**29.0**
Memo						
RBI's net forex purchases	**20.8**	**-2.6**	**8.1**	**9.8**	**24.0**	**18.0**

Source: RBI, Kotak Institutional Equities estimates.

Exhibit 3: Software services provided strong support to invisibles

Invisibles (US$bn)

Item	9MFY07	9MFY06
Travel	1.0	0.8
Transportation	-0.5	-1.1
Insurance	0.4	0.1
Government, not included elsewhere	-0.1	-0.1
Transfers	18.9	16.9
Income	-3.5	-5.2
Investment income	-3.1	-4.7
Compensation of employees	-0.4	-0.5
Miscellenous	24.3	16.7
Software services	20.1	15.6
Overall	**40.5**	**28.1**

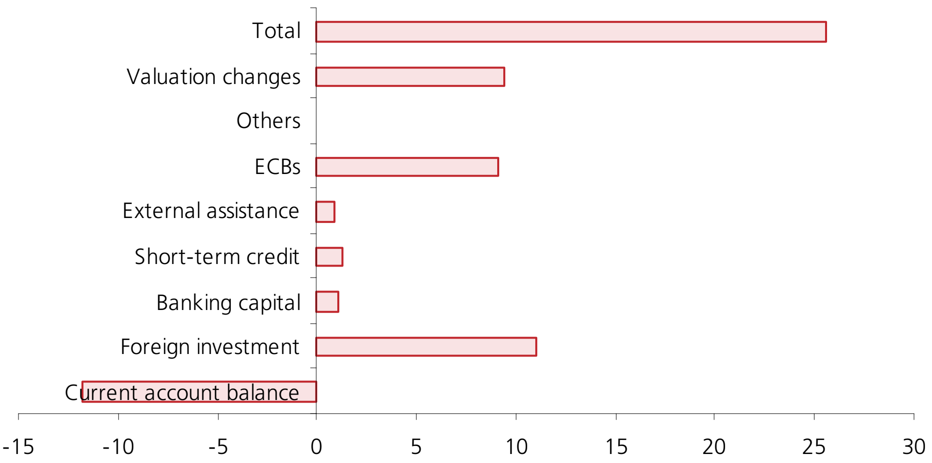
Source: RBI.

Exhibit 4: Business services exports coming of age
(US $ million)

	Net receipts	
	Apr-Dec 2006	Apr-Dec 2005
Communication Services	901	983
Construction	-296	270
Financial	632	273
News Agency	197	51
Royalties, Copyrights & License Fees	-619	-384
Business Services	3995	1522
Personal,Cultural, Recreational	83	12
Others	-771	-1602
Total	4122	1125

Source: RBI.

Exhibit 5: Sources of India's forex reserves
Sources of forex reserves in 3MFY07 (US$ bn)



Source: RBI.

Exhibit 6: Capital flows remain strong
Capital flows (US$bn)

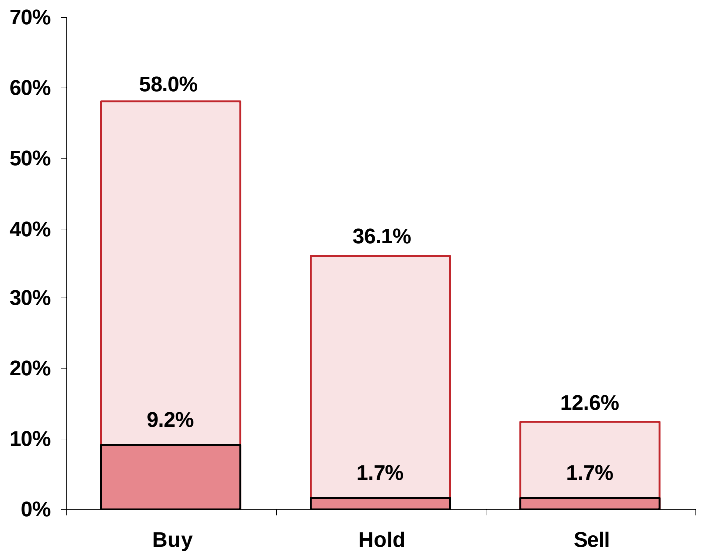
Item	9MFY07	9MFY06
Non-debt creating flows	**11.0**	**11.5**
Foreign direct investment	5.8	3.3
Portfolio investment	5.2	8.2
Debt-creating flows	**16.2**	**2.0**
External assistance	0.9	1.1
External commercial borrowings	9.1	-1.2
NRI deposits	3.2	1.1
Other banking capital	-2.1	0.7
Short-term credit	1.3	1.7
Others	3.8	-1.4
Total	27.2	13.5

Source: RBI.

"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, to the specific recommendations or views expressed in this report: Sanjeev Prasad, Tabassum Inamdar, Puneet Jain, Indranil Sen Gupta."

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 12/31/06 Kotak Institutional Equities Investment Research had investment ratings on 128 equity securities.

Source: Kotak Institutional Equities. *As of December 31, 2006*

Ratings and other definitions/identifiers

Current 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.
CS = Coverage Suspended. Kotak Securities has suspended coverage of this company.
NC = Not Covered. Kotak Securities does not cover this company.
RS = Rating Suspended. Kotak Securities Research has suspended the investment rating and price target, if any, for this stock, because there is not a sufficient fundamental basis for determining an investment rating or target. The previous investment rating and price target, if any, are no longer in effect for this stock and should not be relied upon.
NA = Not Available or Not Applicable. The information is not available for display or is not applicable.
NM = Not Meaningful. The information is not meaningful and is therefore excluded.

Corporate Office
Kotak Securities Ltd.
Bakhtawar, 1st Floor
229, Nariman Point
Mumbai 400 021, India
Tel: +91-22-6634-1100

Overseas Offices
Kotak Mahindra (UK) Ltd.
6th Floor, Portsoken House
155-157 The Minories
London EC 3N 1 LS
Tel: +44-20-7977-6900 / 6940

Kotak Mahindra Inc.
50 Main Street, Suite No.310
Westchester Financial Centre
White Plains, New York 10606
Tel: +1-914-997-6120