

**Initiation of Coverage**

Stock Rating: 1-OVERWEIGHT  
Sector View: 1-POSITIVE  
Ticker: EDEL.NS  
Price (14-Mar-2008): INR 676.15  
Price Target: INR 897.00

INDIA BSE 30 SENSITIVE: 15760.52

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**Analyst Certification**

We, Srikanth Vadlamani and Deepak Reddy, hereby certify (1) that the views expressed in this research Company Report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Company Report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Company Report.

March 19, 2008

<http://www.lehman.com>

# Edelweiss Capital Ltd

## Among the better capital market plays

We believe Edelweiss Capital Ltd's well-diversified business profile, strong management and growth visibility on account of newer businesses gaining traction make it one of the better plays on the Indian capital markets' services space. While the business model is inherently volatile, we believe the current risk-reward profile for the stock is favorable. We initiate coverage with a 1-Overweight rating and a 12-month price target of INR897, representing 33% potential upside.

- We believe the company offers strong growth visibility as newer business lines, such as wholesale finance and asset management, gain traction.
- We value the company on a sum-of-the-parts basis, valuing the institutional equities and investment banking businesses at 22x FY09E earnings, wholesale finance at 3.9x FY09E book value, arbitrage business at 1.1x FY09E book value, and asset management at 15% FY10E asset under management (AUM), to arrive at our price target of INR897.
- Near-term earnings are at risk due to weakness in the current equity markets, especially in the arbitrage business, which exploits the cash-futures arbitrage.

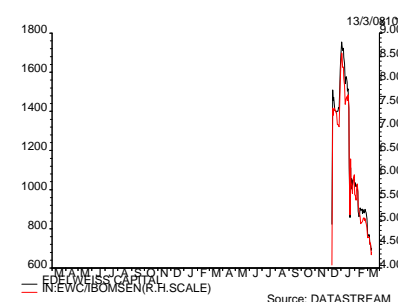
FY Mar (INR)	2007A	2008E	2009E
Adjusted Net Profit	1090.0	2609.0	3521.0
Adjusted EPS	20.6	32.2	43.2
Adjusted PE Ratio	32.6	20.9	15.5
BVPS	110.0	217.0	247.0
P/BV	6.1	3.1	2.7
ROE	28.7	20.3	19.4
Dividend Yield	0.0	1.1	1.7

**Financial Summary**

Net Interest Margin	N/A
Net NPL/Loans	N/A
PL Provisions/Loans	N/A
Tier 1 Ratio	N/A

**Market Data**

Market Cap (mn)	58482.0
Shares Outstanding (mn)	81.0
Free float (%)	30.4
Dividend yield (%)	N/A
Convertible	0
Share per ADR	N/A



Source: DATASTREAM

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**Investment summary**

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**Diversified business model, covering a range of capital market services**

Among providers of capital markets services in India, Edelweiss has one of the most diversified business models in terms of different lines of businesses. We estimate that by FY10, no single business will contribute more than 20% of its revenue, highlighting its diversified business model.

**Newer businesses gaining traction, provide high visibility of growth**

We expect the company to record a robust 42% growth in the top line, translating into 32% growth in the bottom line over FY08-FY10E. Note that our estimates build in a moderation in the activity of capital markets in India, as well as a reduction in the contribution of trading and arbitrage incomes to the overall revenue pool. We believe the visibility of this high growth, in spite of a moderation in market activity, is because newer businesses are gaining traction. The company has been incubating three new businesses: (1) private client services; (2) asset management and (3) wholesale finance over the past two years. We expect these businesses to gain traction and contribute materially to growth in the next two years. We are particularly excited about the wholesale finance business, where we believe that the company is well placed to create value.

**Strong execution record indicates quality of management**

Edelweiss has a strong record of growth. Its revenues recorded a 140% CAGR over FY03-FY07. It has also demonstrated a record of identifying and executing newer business opportunities, which is reflected in the evolution of the company. It has a good risk management record. Edelweiss has also been able to develop and retain key non-promoter management. The above highlights the quality of its management, in our view. In an evolving industry, we believe this is a key differentiator for the company,

**Risk to near-term earnings due to current weakness in equity markets**

With almost all the incumbent businesses being dependent on capital markets (representing 70% of the top line), we believe there is a material risk to near-term earnings given the current weakness in equity markets, and more so if these conditions were to persist. Both institutional brokerage fees and investment-banking activities are impacted by trading volumes in a weak market and because of a lack of investor appetite for new equity issuances. More importantly, the trading and arbitrage business, which exploits cash futures arbitrage, hinges on futures trading at a premium to cash for the trade to be entered into. Over the past few weeks, we have observed that futures contracts have consistently traded at a discount to cash levels. Hence, this business could be impacted from a lack of arbitrage opportunities if the current market scenario persists.

## **Risk-reward is favorable at current levels; initiate coverage with a 1-Overweight rating**

Almost all of Edelweiss' businesses are strongly leveraged to the state of equity markets, so its revenue growth would be volatile to that extent. However, we estimate that its diversified business model provides some natural hedge against too much volatility in its revenue stream. We also view its high dependence on institutional equities for brokerage income, as well as a healthy contribution of non-ECM revenues to investment banking, as positives.

More importantly, we believe that a risk-reward analysis provides a favorable outlook for the stock at current levels. Our base-case assumptions, wherein we have assumed a modest market outlook, works out to be INR897 per share, providing potential upside of 33% from current levels. In our earnings model, we assume the markets stabilize at current levels. A continuation of the bull run over the past three years, on the other hand, would provide meaningful upside to our earnings, and thereby valuations. With a favorable risk-reward, we initiate coverage of the stock with a 1-Overweight rating and a 12-month price target of INR897.

**Figure 1: Valuation summary**

<b>Business</b>	<b>Valuation methodology</b>	<b>Valuation (INR mn)</b>
Institutional equities	22x FY09E earnings	14,602
Investment banking	22x FY09E earnings	8,003
Asset management	15% of FY10E AUM of US\$2 bn	9,000
Private client services	20x FY09E earnings	9,760
Trading and arbitrage	1.1x FY09E BV	11,706
ECL finance	3.9x FY09E BV	17,059
Investment and dividend income	8x FY09E earnings	2,852
<b>Total value of Edelweiss</b>		<b>72,983</b>
<b>Value/share (INR)</b>		<b>897</b>
<b>Implied firm P/E (x)</b>		<b>16</b>
<b>Implied firm P/BV (x)</b>		<b>3.1</b>

*Source: Lehman Brothers estimates*

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**Investment risks**

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**Market risk**

On account of its dependence on activity in the capital markets, the revenue stream of the company does indeed carry a material amount of market risk.

- Investment banking activities are cyclical in nature; in particular, the propensity for IPOs and follow-on offers from corporates is subject to benevolent conditions prevalent in equity markets.
- Institutional brokerage revenue, being levied on traded value rather than on traded quantity, would be affected if the markets were to trade at lower levels.
- The company's trading and arbitrage business hinges on opportunities for cash futures arbitrage, which can be entered into only if the futures price is at a premium to the spot market price.

**High contribution from trading/arbitrage business**

The trading and arbitrage business of the company contributes over 25% to the consolidated revenue. There is a risk that the company may not be able to scale up this business, given that the trading book has grown strongly and reduced the existence of opportunities to take arbitrage positions on a larger scale. Moreover, the success of the arbitrage positions depends on such arbitrage opportunities, which may turn infeasible based on market movements.

**Ability to scale up the asset management business**

The bulk of the company's assets under management (AUM), i.e. the multi-strategy INR18 billion fund, is deployed in the trading/arbitrage business. Hence, the ability to scale up AUM is at risk, in line with the risks associated with the arbitrage business.

## Valuation and rating

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We value Edelweiss using a sum-of-the-parts (SOTP) methodology, considering that it now has six reasonably distinct businesses.

We value the three agency businesses — institutional equities, investment banking and private client services — on a P/E multiple basis. In our base case, we value them at 22x FY09E earnings. We value its asset management at 15% of FY10E AUM.

We value the two balance-sheet-based businesses — trading and arbitrage and wholesale finance — on a P/BV basis. We value the wholesale finance at 3.9x FY09E BV. We believe this is an interesting business area, with Edelweiss enjoying a first-mover advantage as well as synergies from existing businesses. The trading and arbitrage business, however, has been valued at 1.1x the invested capital in that business. The lower multiple is to reflect the inherently opaque nature of the business.

Almost all businesses of Edelweiss are strongly leveraged to the state of the equity markets. Its revenue growth would be volatile to that extent. However, we estimate that its diversified business model provides some natural hedge against too much volatility in its revenue stream. We also view its high dependence on institutional equities for brokerage income as well as a healthy contribution of non-ECM revenue to investment banking as positives.

More importantly, we believe that a risk-reward analysis provides a favorable outlook to the stock at current levels. Our base-case value, in which we have assumed a modest market outlook, works out to be INR897 per share, suggesting potential upside of 33% from current levels. In our earnings model, we assume that markets stabilize at current levels. A continuation of the bull-run over the past three years, on the other hand, would provide meaningful upside to our earnings, and thereby valuations. With a favourable risk-reward, we initiate coverage of the stock with a 1-Overweight rating and a 12-month price target of INR897.

### **Valuation methodology – sum-of-the-parts is the most appropriate**

We value Edelweiss using a sum-of-the-parts (SOTP) methodology, considering that it now has six reasonably distinct businesses.

We segregate the businesses into three buckets from a valuation methodology perspective.

- **Existing traditional businesses.** We believe the institutional equities and investment banking businesses are relatively mature businesses from the perspective of Edelweiss's market share. Growth in these businesses would be materially impacted by overall market growth. The valuation multiple to be assigned to these businesses has to factor in the inherent volatility of the broader market.

- **Nascent businesses.** The valuation of the two nascent businesses — asset management and wholesale finance — has to factor in their different market environments. We believe the wholesale finance business represents a virgin opportunity. Edelweiss, on account of its first-mover advantage and synergies of this business with other businesses, should get a premium. Growth in the asset management business, on the other hand, is more a function of the level of international institutional interest in the India growth story, in our view.
- **Proprietary businesses.** This is probably the most challenging business from a valuation perspective. Revenue in this business has grown at a robust pace and the company has so far been able to show a remarkable consistency in the returns generated. On the other hand, external investors may have a limited understanding in terms of how the returns are generated. This raises questions regarding the sustainability of this revenue stream, which should be reflected in valuations, in our view.

### Valuing the individual segments

We value the three agency businesses — institutional equities, investment banking and private client services — on a P/E multiple basis. In our base case, we value them at 22x FY09E earnings. We value the asset management at 15% of FY10E AUM.

We value the two balance sheet-based businesses — trading and arbitrage and wholesale finance — on a P/BV basis. We value the wholesale finance at 3.9x FY09E BV. We believe this is an interesting business area, with Edelweiss enjoying a first-mover advantage as well as synergies from its existing businesses. The trading and arbitrage business, however, has been valued at 1.1x the invested capital in that business. The lower multiple is to reflect the inherently opaque nature of the business.

Figure 2: Valuation summary

Business	Valuation methodology	Valuation (INR mn)
Institutional equities	22x FY09E earnings	14,602
Investment banking	22x FY09E earnings	8,003
Asset management	15% of FY10E AUM of US\$2 bn	9,000
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<b>Implied firm P/BV (x)</b>		<b>3.1</b>

Source: Lehman Brothers estimates

## **Institutional equities**

### **Key valuation drivers**

- We believe the volatility in institutional trading volumes will be lower than that in retail trading volumes. Also, structurally, we believe the proportion of institutional volumes in the overall volumes will rise in tandem with the increase in institutional ownership share.
- We believe competition is intensifying in the institutional trading space. We are building in stable market shares for Edelweiss in the next two years.
- We are building in market growth of 14% each in FY09E and FY10E, after taking the closing level of January 2008 as a base.

### **Valuation methodology**

We value the business on a P/E basis, assigning it a multiple of 22x FY09E earnings. While this multiple is in line with that of the broader market, we note the expected top-line growth in this business is 31% over the next two years.

## **Investment banking**

### **Key valuation drivers**

- Edelweiss derives 50% of its revenue from the non-public market capital. We believe this offers a cushion against a slowdown in new public market issues in case of a market slowdown.
- We are building in a 37% CAGR in investment banking revenue over FY08-FY10. We believe there could be material upside to these numbers in the event of positive market conditions.

### **Valuation methodology**

We value this business on a P/E basis, assigning it a multiple of 22x FY09E earnings. This multiple is line with our valuation multiple for the institutional equities business.

## **Private client services**

### **Key valuation drivers**

- It is a nascent business well-positioned for growth, with the company having made significant investments over the past two years.
- There is some downside risk to growth if markets see a prolonged correction. However, we highlight that the company currently enjoys the benefit of a low base.

### **Valuation methodology**

We value this business on a P/E basis, assigning it a multiple of 25x FY09E earnings. This is at a slight premium to our valuation multiple for the institutional business, reflecting its relatively nascent state.



**Asset management****Key valuation drivers**

- We assume AUM of US\$2 billion by FY10 vs current US\$550 million. Of the US\$2 billion, we build in US\$750 million in the multi-strategy fund.
- The proportional size of AUM to our assumed level would be contingent upon the overall market environment, on whether it continues to be supportive. The company is yet to build a distribution network and a good record (except in the multi-strategy fund).
- A large part of the AUM would be in the multi-strategy fund. Edelweiss has an exceptional record so far, which has enabled it to scale up this fund. The key challenge is to consistently maintain this performance, as these funds have a very long lock-in period.

**Valuation methodology**

We value this business at 15% of FY10E AUM. Profitability in this business is high on account of its 2:20 fee structure. However, we believe our valuation has downside risk, as the size of AUM is susceptible to developments in the markets as well as the high contribution of the multi-strategy fund to the overall AUM.

**Wholesale finance****Key valuation drivers**

- Virgin business area, with only limited players and a large opportunity.
- We believe Edelweiss will have a sustainable competitive advantage in this business unit because: (1) it has one of the largest books in terms of capital invested in the business, which would give it crucial flexibility in doing large deals; 2) a first-mover advantage, with only a few players currently active in this business; and, 3) synergies with the rest of its businesses in terms of origination and risk management.
- We believe growth can surprise on the upside as demand is very strong. A key constraint to ramping up growth faster than our expectations would be the extent of leverage that this business can take.

**Valuation methodology**

We value this business at 3.9x FY09E BV. We believe there can be upside to our valuations on account of higher growth.

**Trading and arbitrage****Key valuation drivers**

- Ability to deploy a much larger amount for trading and arbitraging without affecting returns.
- Ability to generate returns in a weak market, especially when cash futures arbitrage opportunities may dry up.

### Valuation methodology

We value this business at 1.1x FY09E invested capital. We have not assumed growth in capital allocated to this business in the next two years.

### Risk-reward is favorable at current levels; initiate coverage with 1-OW

Almost all businesses of Edelweiss are strongly leveraged to the state of the equity markets. Its revenue growth would be volatile to that extent. However, we estimate that its diversified business model provides some natural hedge against too much volatility in its revenue stream. We also view its high dependence on institutional equities for brokerage income and a healthy contribution of non-ECM revenue to investment banking as positives.

More importantly, we believe our risk-reward analysis provides a favorable outlook to the stock at current levels. Our base-case value, wherein we have assumed a modest market outlook, works out to be INR897 per share, providing potential upside of 33% from current levels. In our earnings model, we have assumed that the markets stabilize at current levels. A continuation of the bull run underway over the past three years on the other hand, would provide meaningful upside to our earnings, and thereby valuations. With the risk-reward being favorable, we initiate coverage with a 1-Overweight investment rating and a 12-month price target of INR897.

**Figure 3: Valuation summary – base case**

Business	Valuation methodology	Valuation (INR mn)
Institutional equities	22x FY09E earnings	14,602
Investment banking	22x FY09E earnings	8,003
Asset management	15% of FY10E AUM of US\$2 bn	9,000
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*Source: Lehman Brothers estimates*

Figure 4: Peer group valuation comparables

	Bloomberg Ticker	Rating	Price INR	P/B			P/E			ROE		
				08E	09E	10E	08E	09E	10E	08E	09E	10E
India Brokers												
Edelweiss Capital	EDEL IN	1-OW	671	2.8	2.4	n.a.	25.9	17.4	n.a.	n.a.	n.a.	n.a.
India Infoline	IIFL IN	Not rated	799	6.1	4.4	3.2	28.2	15.9	11.1	27.5	27.5	29.2
Religare Enterpr	RELG IN	Not rated	394	5.0	4.3	3.1	30.3	19.5	13.3	20.6	23.7	26.0
Motilal Oswal	MOFS IN	Not rated	655	2.4	1.8	1.3	11.2	7.5	5.6	30.7	30.5	29.7
Reliance Capital	RCFT IN	Not rated	1294	5.2	4.5	3.8	36.3	28.3	22.6	14.2	15.8	16.8
Indiabulls Finan	IBULL IN	Not rated	470	2.5	2.0	1.7	15.2	11.5	9.0	20.1	20.2	21.1
Geojit Financial	GFSL IN	Not rated	50	4.1	3.0	n.a.	23.6	11.0	n.a.	21.7	33.0	n.a.
Regional Brokers												
Citic Securities	600030 CH	1-OW	56 (CNY)	4.3	3.5	2.5	17.1	13.1	9.9	31.2	27.0	25.7
Daiwa Secs Grp	8601JP	1-OW	864 (JPY)	1.3	1.2	1.1	14.6	13.7	12.9	8.3	9.0	9.7
Nomura Holdings	8604 JP	1-OW	1463 (JPY)	1.2	1.2	1.1	21.7	13.6	13.3	5.7	8.8	9.5

Note: Pricing as of 13 March 2008. Source: Lehman Brothers estimates for Edelweiss; Bloomberg consensus estimates for other stocks

## Financials

We expect a robust 42% growth in the consolidated revenue of Edelweiss, translating into 32% bottom-line growth over FY08-FY10E.

We expect growth in institutional equities and investment banking to moderate, in line with our expectations of a moderation in the overall market growth rates.

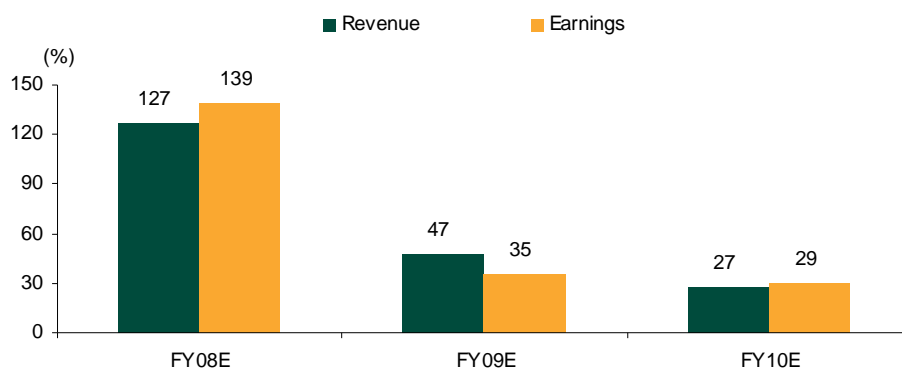
We expect margin growth to be driven by three new businesses — wholesale finance, asset management and private client services. We expect these three segments to contribute 69% of growth over the next two years.

With almost all of its businesses linked to capital markets, revenue growth will be affected by overall market conditions, in our view. We estimate that there is a material risk to our near-term earnings if the markets remain lukewarm.

Edelweiss has enjoyed high profitability so far. We expect the company to continue to report high return on assets (RoA). Expansion in return on equity (RoE), however, may be limited on account of low leverage, primarily due to the types of businesses it engages in. Both the arbitrage business and the wholesale finance units are linked to the capital markets, and hence are seen as being risky. Creditors and credit-rating agencies may want to view how the business pans out before getting comfortable with higher levels of leverage.

### Robust growth expected over the next two years

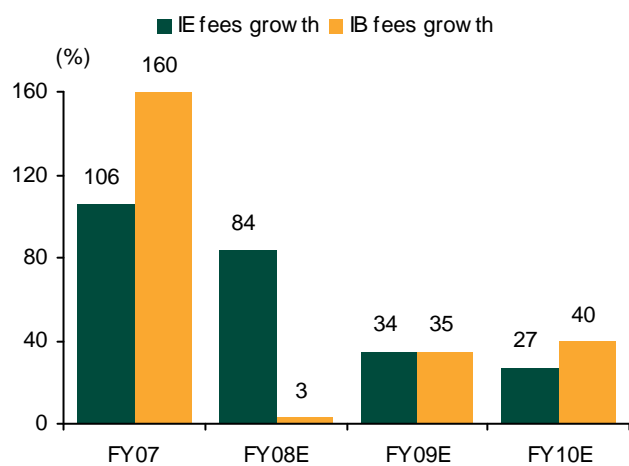
Figure 5: Revenue and earnings growth



Source: Company data, Lehman Brothers estimates

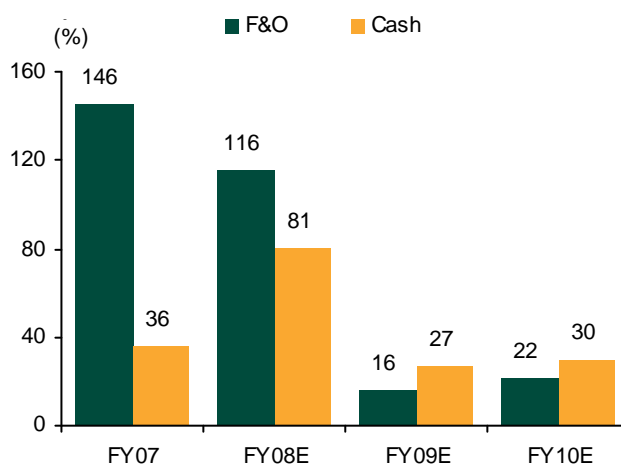
## Slowdown in growth in institutional equities and investment banking on account of slower market growth

Figure 6: Growth in investment banking and institutional broking fees



Source: Company data, Lehman Brothers estimates

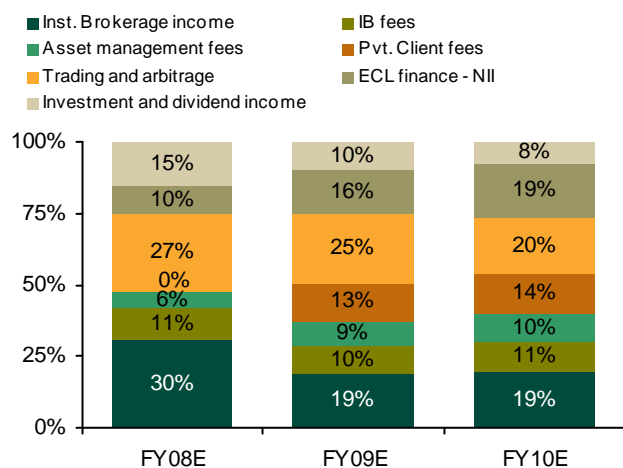
Figure 7: Market growth in institutional trading volumes



Source: National Stock Exchange of India (NSE), Bombay Stock Exchange (BSE), Lehman Brothers estimates

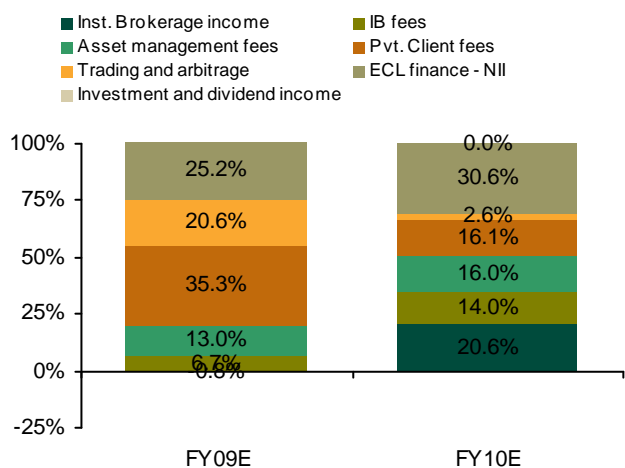
## Margin growth to be driven by newer businesses

Figure 8: Revenue contributions



Source: Lehman Brothers estimates

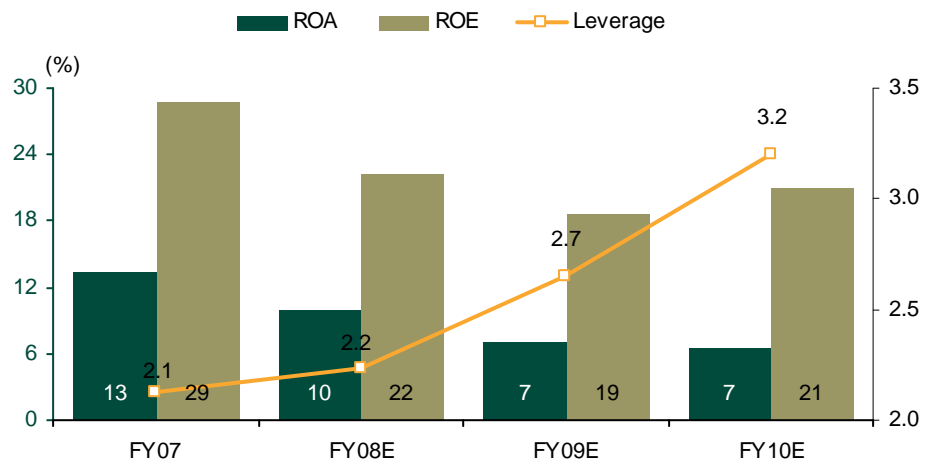
Figure 9: Contribution to revenue growth



Source: Lehman Brothers estimates

### Profitability to remain high, expansion in ROE to be constrained on account of low leverage

Figure 10: Movement in ROE, ROA and leverage



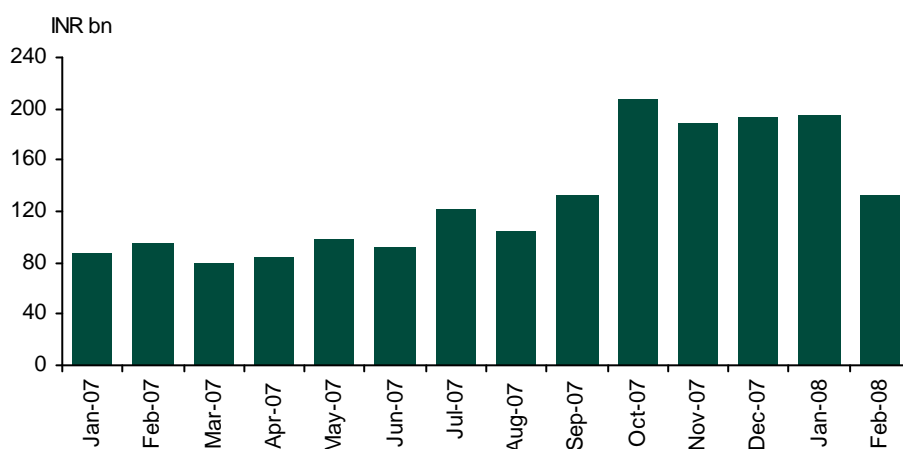
Source: Company data, Lehman Brothers estimates

## Risk to near-term earnings due to current weakness in equities

### Institutional broking revenue and investment banking activities directly correlated to market sentiment

We highlight that historically, the velocity in the institutional segment has a lower correlation with the level of equity markets in India as opposed to retail velocity, which is very sensitive to equity market performance. However, in India, brokerage fees are charged on traded value as opposed to traded quantity as practiced in certain developed markets. Hence, if market conditions are subdued, brokerage fees will be affected significantly. Over the past few weeks, overall trading volumes in both the cash and derivatives markets have dropped substantially. If these sluggish market conditions persist for a few months, the fee income stream from the institutional segment would be materially impacted, possibly resulting in weak short-term earnings.

Figure 11: Average daily turnover in cash – monthly



Source: NSE, Lehman Brothers research

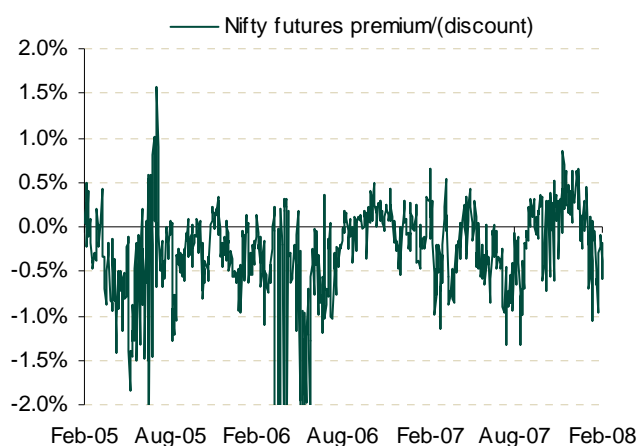
However, we are building in 1.1% monthly returns in the market over the next two years, which translates to a moderate annual return of 14%. Hence, our industry turnover estimates and Edelweiss's valuations do not build in a scenario of strong market returns.

Investment banking activities are cyclical in nature, especially in the equity capital markets where IPO and follow-on offers are clearly subject to benevolent conditions in the equity markets. In the past couple of months, there have been instances of proposed public issues being withdrawn from the market due to a lack of adequate investor appetite. Hence, we would caution on weakness in near-term earnings.

## Trading and arbitrage business opportunities dependent on futures trading at premium to cash

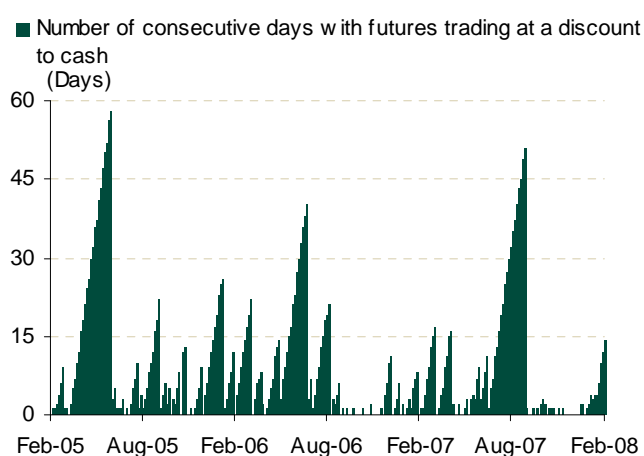
This business aims to make profits primarily from the cash futures arbitrage. Whenever the futures on a particular instrument are trading at a premium to the underlying stock/index, one can make an almost risk-less profit by buying in cash and selling in futures. However, the current bearish sentiment in the market has caused the index futures to trade at a discount to the spot levels, for the past few weeks. Clearly, a cash futures arbitrage position cannot be entered into in such a scenario.

Figure 12: Nifty futures premium/(discount) to cash



Source: NSE, Lehman Brothers research

Figure 13: Number of consecutive days with futures trading at a discount to cash



Source: NSE, Lehman Brothers research

The above trend is based only on the closing prices of the futures contract. There could still be arbitrage opportunities if the intraday futures prices are above the spot prices. There have been such instances in the current period.

We note that over the past few years, there have been periods when futures traded at a discount for over 25-30 days consecutively. But seen over a period of one year, Edelweiss has managed to generate strong profits in this business.

Nevertheless, we believe the direction of the futures premium/discount in the past few weeks indicates fewer opportunities for Edelweiss to enter into the cash futures arbitrage trading. Hence, if the current weak market conditions prevail, this particular business of Edelweiss would clearly be affected and earnings would be materially impacted in the short term.



## Business outlook

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Given that almost all of Edelweiss' businesses are linked to the capital markets, the business outlook for Edelweiss will be dependent on the state of the markets. However, we believe the business model of the company is markedly different from that of its peers because: (1) some of its businesses are just emerging from an incubation stage, and hence would benefit from a low base; and, (2) it has the ability to deploy a large balance sheet in market-neutral opportunities.

We expect the two traditional agency businesses — institutional equities and investment banking — to continue to grow at a robust pace. We do note that the institutional equities business (for the entire sector) has witnessed outstanding growth over the past few years. So far, FY08 has been exceptionally good, with the market touching new highs and trading velocity picking up as well. Growth should indeed moderate due to the high base. However, we believe the equity markets will be one of the key beneficiaries of the structural upturn in the Indian economy. This should provide earnings visibility over the long term for this business.

In the investment banking division, Edelweiss operates in the mid-market segment. We believe its deal pipeline is strong and do not foresee too much of a base effect at work here. However, this business would be sensitive to overall market sentiment. A sharp or sustained correction in the equity markets would impact this business in the short term. With markets not being cheap and uncertainty plaguing the global economy, there is indeed a chance of the current bull run taking a breather this year. On the other hand, strong expansion plans by corporates mean that fundraising opportunities would likely continue to be strong. Overall, we are building in robust growth in this segment, albeit at moderated levels vis-à-vis FY08.

The trading and arbitrage division of Edelweiss is one of its key competition differentiators. Unfortunately, by its very nature, it is also its most opaque part. The company has demonstrated a record of consistent returns in this business. The key challenge would be its ability to deploy increasingly large amounts of capital, without compromising the returns. We have assumed a conservative estimate the amount of capital that would be deployed in this business. We do recognize the 'fat-tailed' characteristics of this business, and hence have valued it in on a P/B basis.

Wholesale finance is one of the three nascent businesses in the company's product suite and is expected to be a key growth driver. The business model is primarily lending against shares and other marketable securities. We note that there is a regulatory arbitrage in this space, as banks can have a very limited exposure to this segment. On the other hand, buoyant equity markets have meant that there is material equity wealth lying on the balance sheets of promoters/high net worth individuals (HNWIs), which they may want to leverage. With a proper risk management system in place, we believe this can be a very profitable business.

The company is also looking to build up its asset management business. It has currently INR28 billion under management. Its multi-strategy fund, which broadly follows the same investment philosophy as that of its proprietary book, has scaled up to INR18 billion in a relatively short period of time. We have been conservative in building in its expansions in other/new funds, primarily because of their limited record in this business.

Private client business is another key area of growth. Edelweiss has invested in people and systems over the past one year. It is already seeing some traction in private client broking. We expect this segment to continue to show strong growth rates, cushioned by a low base.

### **Institutional equities**

The institutional equities market has seen a rather spectacular growth rate over the past few years. The steep rise in market levels, a pick-up in institutional ownership as well as number of new companies getting listed have contributed to this spurt in volumes.

We expect growth in the medium term to continue to be robust. This is primarily based on the assumption that the Indian economy will grow at a fairly fast pace over the next decade. With a favorable economic backdrop, we believe equity markets, institutional interest and consequently trading volumes will be healthy.

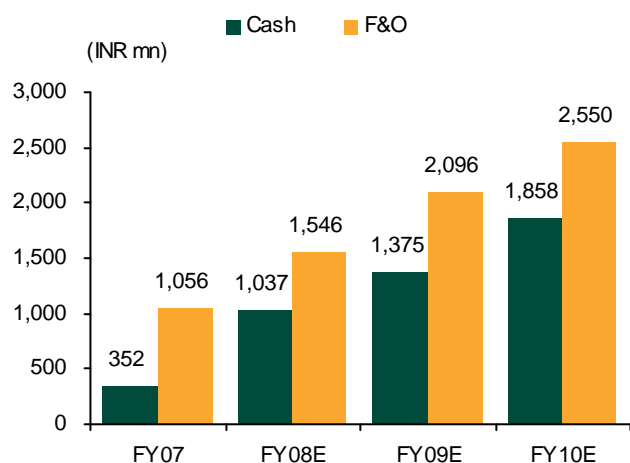
Growth over the next year, however, should moderate compared with FY08. So far, FY08 has been an exceptionally good year for stock brokers. Stock market prices have spiked, accompanied by an increase in trading velocity as well. We are building in only a moderate rise in the market levels next year. This would imply that growth in trading volumes would also moderate. Note that in India, brokers charge commissions based on the rupee value of the trade. Hence, commission income is related to market levels and is volatile to that extent. Please refer to our section on the Indian equity markets for a detailed discussion on market trends.

Edelweiss is one of the top institutional brokers in India. In the futures and options (F&O) segment, it would rank as the top domestic broker. In the cash segment, we estimate that it would be among the top five.

Edelweiss was one of the early movers in the F&O segment and has built up strong execution capabilities. We expect it to sustain its premier position in the F&O segment. Note that competition from foreign brokers is relatively less in this space. A significant amount of volumes in the segment is from proprietary books of investment banks engaging in the cash futures arbitrage trade, in which a large part of this trade is directed to domestic brokers rather than to other foreign brokers.

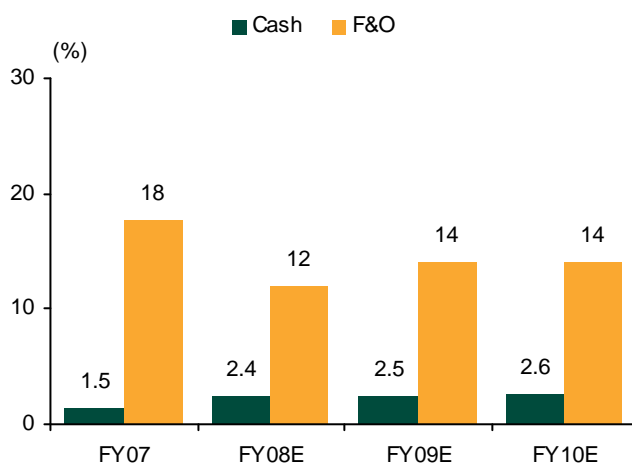
In the cash segment, Edelweiss has been investing to build a research franchise in the past two years. It now has 215 companies under active coverage. However, we do note that the institutional equities market has seen the entry of quite a few new players over the past one year. We believe competition has intensified in this sector. Under such a scenario, we do not expect any material market share gains for Edelweiss.

Figure 14: Institutional broking revenue



Source: Company data; Lehman Brothers estimates

Figure 15: Institutional broking market shares



Source: Company data; Lehman Brothers estimates

## Investment banking

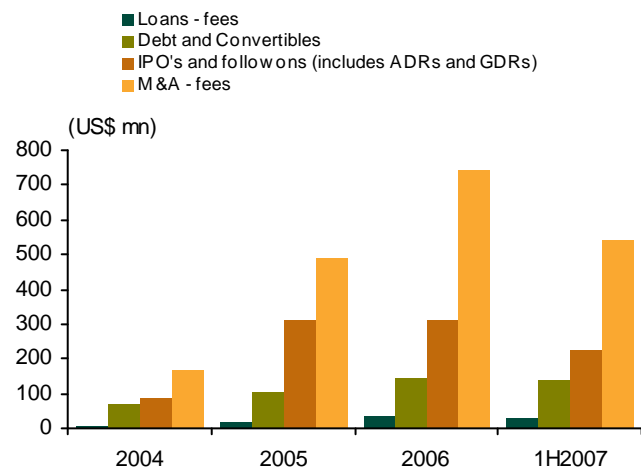
The strong investor sentiment in the Indian equity market and positive macroeconomic conditions have supported healthy IPO developments and trading activities in the primary and secondary markets. With liquidity remaining strong in India, and corporate profits rising faster than expectations, growth in investment banking should continue to pick up pace. The outlook for brokerage firms in India is bright, in our opinion, given the amount of fees they can earn from helping to raise funds in the market.

The macroeconomic favorable conditions have also helped the M&A market, where activity has been exceedingly strong. India currently ranks number four in the Asia-Pacific region in terms of M&A activity. A rise in volume will bring in advisory fees for broker-dealers, strengthening their balance sheet over the next few years.

Investment banking has been a direct beneficiary of the strength in the Indian economy and equity markets. Deal flow has been extremely strong, especially on the fundraising side. While clearly contingent on the state of the markets, healthy economic growth in India and the strong expansion plans of corporates should ensure strong investment banking pipeline, in our view.

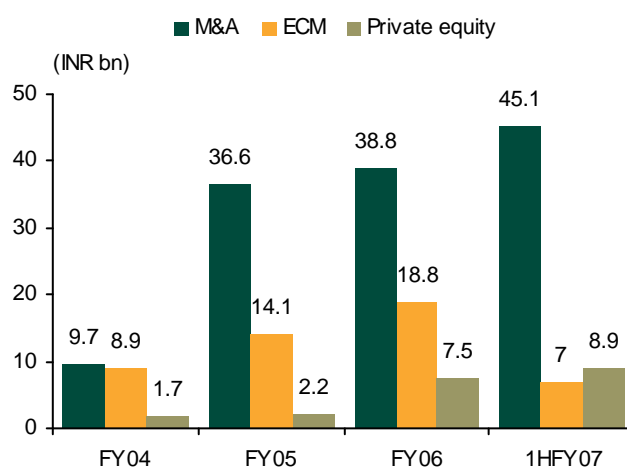
This is especially so for Edelweiss, considering the segment it is in. Edelweiss is a major player in the mid-market investment banking segment, wherein the typical deal size is INR0.3 billion to INR3.0 billion. We also believe Edelweiss will be cushioned by its revenue mix, with the company generating around 50% of its fees from non-public market deals, either in M&A or private company deals. Note that there is a significant amount of private equity money looking for investing opportunities in India, which bode well for deal flow in the private company space, in our view.

Figure 16: Investment banking fee pool size



Source: Thomson Financial

Figure 17: Investment banking transaction volumes



Source: Bloomberg, Lehman Brothers estimates

Figure 18: Private equity money raised by Indian firms

Firm	Amount US\$ mn	Sector	Status
IL&FS	578	Real estate	Committed
Indiareit (Piramal Group)	750	Real estate	Proposed
Stanchart (in JV with ILFS)	1000	Infrastructure	Proposed
HDFC	1000	Real estate	Proposed
IDFC	500	Infrastructure	Proposed
IDFC	1000	Infrastructure	Proposed
IDFC	500	PE	Proposed
Kotak India Real Estate	200	Real estate	Proposed
Kotak Investment Advisors	1000	Infrastructure	Proposed
Macquarie-IFC JV	1000	Infrastructure	Proposed
PFC	1000	Infrastructure	Proposed
ICICI Venture	3000	Infrastructure	Proposed
ICICI Venture	2000	Real estate	Proposed
ICICI Venture	2000	PE	Proposed
FutureCapital (JV with Real Term Global)	350	Logistics	Proposed
Axis PE	500	Infrastructure	Proposed
Motilal Oswal	125	PE	Committed

Source: Lehman Brothers research

### Trading and arbitrage income

The trading and arbitrage part of the business is the most opaque part of the company's revenue model. The business model consists of generating profits by employing the firm's balance sheet in trading and arbitrage opportunities.

Management has indicated that the bulk of the activity on this book is from arbitrage trading, implying the company takes very little market risk.

In India, trading opportunities that provide a certain amount of return with very minimal market risk do indeed exist from time to time. One of the biggest strategies in this class is the cash futures arbitrage. Whenever the futures on a particular instrument are trading at a premium to the underlying stock, one can make a profit by buying in cash and selling in futures. The rate of return depends upon the premium at which the futures contract is trading vis-à-vis the spot. This trade is profitable whenever the rate of return is greater than the acceptable threshold return.

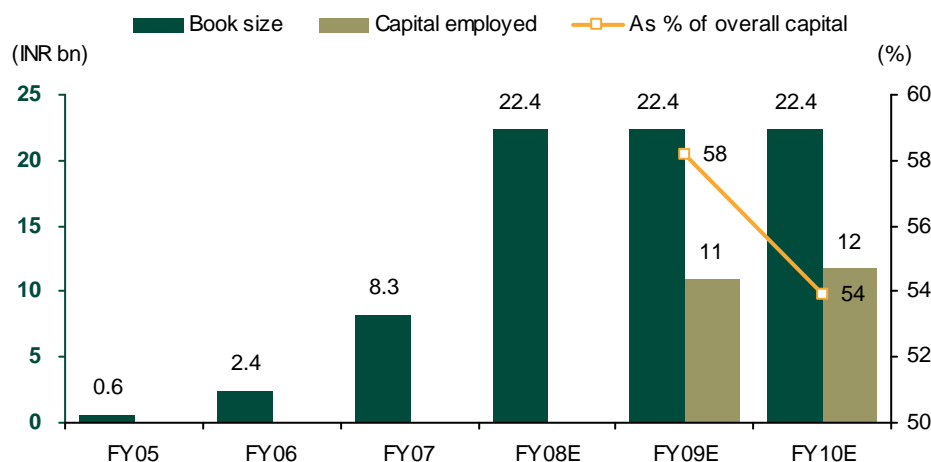
Key advantages that brokers have over other investors in these type of strategies are: (1) brokerage costs savings; and, (2) the set off of securities transaction tax (STT) as a business expense. These two would save 5bp per month in returns, which otherwise would have been netted off.

The company has claimed to have an established a record in this business. It indicated that it had several un-interrupted months of positive returns from this desk.

Assuming that Edelweiss has been able to manage risk well, we see three key challenges to this business as follows.

- **Ability to scale up the amount of capital deployed into this business.** Management has indicated that it targets 1.5-2% monthly return on the invested amount. It implies that this business is currently employing an average capital of INR20 billion, a significant ramp up from the past. We believe that sustaining this level would be a challenge, although management is confident about it. In our earnings model, we have assumed the capital deployed in this business remains at current levels.
- **Prevalence of arbitrage opportunities in a bear market.** One of the biggest arbitrage strategies is the cash futures arbitrage. The sustainability of this strategy is predicated upon futures trading at a material premium to spot, something which would not be seen too much in a bear market. Admittedly, this is only one of the strategies that are being employed by the company. But it does highlight the challenge in sustaining a steady state of revenue on a large amount of capital.
- **The change in treatment of Securities Transaction Tax (STT) is a material negative.** In the recent budget, it has been proposed to change how STT is accounted for. Hitherto, STT was allowed to be directly set-off from tax. However, under the proposed change, STT would only be allowed as a tax-deductible expense. We believe that this would materially impact the net returns generated on this business.

Figure 19: Amount of capital employed in the trading/arbitrage business



Source: Lehman Brothers estimates

### Wholesale financing

The company is in the business of wholesale finance through its subsidiary ECL Finance, in which it has a 63% stake. The subsidiary will primarily finance loans against securities. This could be loans against securities, IPO financing or loans against mutual fund shares.

We believe that this business presents a large and profitable opportunity, given the following.

- There is a regulatory arbitrage for non-banking financial companies (NBFC) in this market, as there are significant restrictions on banks from having exposure to assets with securities as the underlying collateral.
- The opportunity, on the other hand, is quite large. The burgeoning equity markets have undoubtedly created immense wealth in the hands of some individuals, with promoters or HNWIs. This business model aims at helping this segment to monetize this part of their balance sheet.

Note that this business model is different from margin financing. While the underlying collaterals are securities in both cases, margin financing involves providing very short-term loans for trading business. On the other hand, wholesale financing involves loans of relatively longer tenure (up to 18 months) and the end-user need not be trading in the equity markets.

The key to this business is risk management. We understand that Edelweiss typically takes in a margin of 50-70% on these loans. Given proper risk management, we believe that this business can be very profitable. Conceptually, the high profitability of this model would be primarily on account of the regulatory arbitrage existing. Not only can banks not enter this business, it can also demand a level of sophistication in risk management.

A key advantage of the company is the size of the equity book in ECL Finance. We estimate that this would be among the largest in the sector. This would be a competitive advantage, as it would enable the company to conduct deals that would be out of reach for its peer group.

The business has ramped up significantly since its inception at end-FY06. Currently, it has a book size of INR2.2 billion. We estimate that it could be INR40 billion in FY10E.

**Figure 20: Indicative profitability in the segment**

	2% slippages	3% slippages	4% slippages
Lending yields (%)	18	18	18
Cost of funds (%)	10	10	10
Slippages (%)	2.0	3.0	4.0
Provisions (%)	2.0	3.0	4.0
Cost-income ratio (%)	35	35	35
Tax rate (%)	30	30	30
ROA (%)	2.3	1.7	1.1
Target leverage	8	8	8
ROE (%)	18.7	13.6	8.6

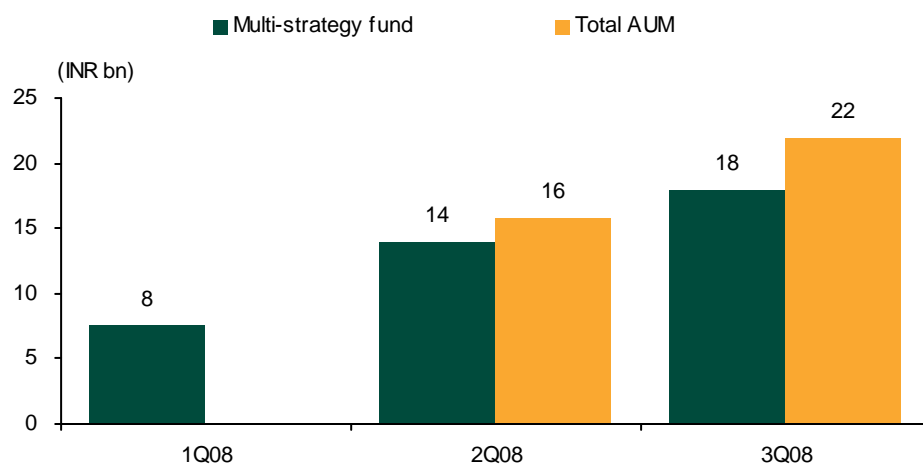
Source: Lehman Brothers estimates

### Asset management

The asset management division is one of the focus areas of the company, with plans for a significant ramp-up.

Currently, it has INR28 billion of AUM (including partly owned funds), among which INR18 billion is in the multi-strategy fund, INR6 billion is in a private equity fund and INR1 billion each in a real estate fund and in private wealth management. While this business is relatively new, it has shown very healthy growth, as shown in the graph below.

**Figure 21: Assets under management (AUM)**

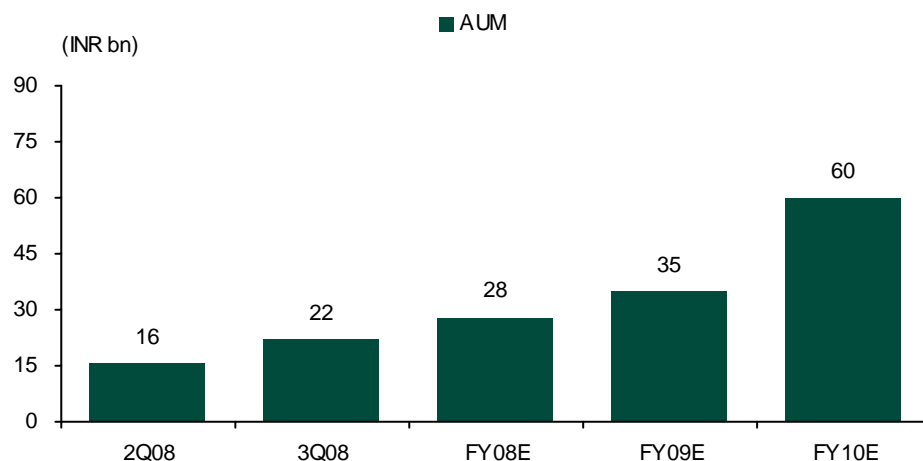


Source: Company data, Lehman Brothers estimates

Growth in AUM is currently being driven by the multi-strategy fund, whose investment philosophy is broadly in line with the company's proprietary book. Edelweiss has demonstrated success in this particular investing style, evidenced by the strong interest in this fund. We expect this fund to be further ramped up.

Edelweiss also has plans to start funds with more traditional investment strategies. We would expect a ramp up of these funds to be much more measured, primarily as the company has yet to build a record here. However, we do note that there seems to be a lot of interest for India-dedicated funds from international investors. This could lend upside to our AUM estimates.

Figure 22: Estimates of movement in AUM



Source: Company data, Lehman Brothers estimates

### Private client and wealth management

Edelweiss started research-based brokerage services in 2004 for high net worth individual (HNWI) clients. It is one of the emerging business segments for the company, which could potentially develop into a fully fledged retail foray at some time in the future. It also has a wealth management division that targets HNWI clients with a diverse set of product offering, ranging from asset allocation advisory, structured products, distributing real estate funds to art funds.

We would like to highlight that the company has significantly invested in incubating these two businesses. It now has around 80 relationship managers in each of these two divisions, spread over 12 cities. We believe that this should now translate into a corresponding jump in top-line growth. Note that the run-rate in these businesses is only INR60 million per month, indicating that the base is very low. This should enable the company to show strong growth rates for at least the next two years, in our view.



## Company background

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### Background

Edelweiss is a diversified financial services company in India, providing investment banking, institutional equities, private client broking, asset management, wealth management, insurance broking, and wholesale financing services to corporate, institutional and, HNWI clients. The company was co-founded by Mr Rashesh Shah and Mr Venkatchalam Ramaswamy in 1995. The company has grown from a boutique investment bank into a diversified Indian financial services company, organized under agency and capital business lines and operates along its nine subsidiaries. The agency business lines include investment banking, institutional equities, private client broking, asset management, wealth management, and insurance broking, while the capital business lines include wholesale financing services and our internal treasury operations.

### Management profiles

Co-founder Mr Rashesh Shah is the Chairman, CEO and Managing Director of Edelweiss. Mr Shah has 18 years of experience in public and private markets in India. Mr Shah holds a bachelor's degree in science from Bombay University and a PGDBM from the Indian Institute of Management, Ahmedabad. Previously, he was the Head of Research at Prime Securities Private Limited and a Manager at ICICI Limited. He has also handled a World Bank aided program for export-oriented projects at ICICI Limited. Mr Shah has been associated with the company since 1995 as CEO and MD.

Co-founder Mr Venkatchalam Ramaswamy has been the Head of Investment Banking where his focus has been on venture capital and private equity advisory and fund raising for emerging technology companies. He holds a bachelor's degree in engineering from Karnataka University and masters degree in business administration from University of Pittsburgh. Previously, Mr Ramaswamy was a fund manager at Spartek Emerging Opportunities of India Fund. Mr Ramaswamy was an Assistant Manager at ICICI Limited and Assistant Manager at Tata Unisys Limited.

Mr Anurag Madan is the Chief Operating Officer of the company. He assumed the role of Chief Operating Officer in Edelweiss Securities Limited in February 2005. He holds a bachelor's degree in Economics from University of Delhi. He is an associate of the Indian Institute of Bankers and is a Chartered Financial Planner of the Financial Planning Standards Board of India. Previously, Mr Madan was the Chief Operating Officer at SUN F&C Asset Management Company and an Assistant General Manager at State Bank of India. Mr Madan has more than 30 years of experience in the financial services industry and has been associated with the State Bank of India for 23 years.

Mr Deepak Mittal is the Chief Financial Officer of the company. He was earlier the Head, Treasury Operations and managed treasury function in one of the subsidiaries, Edelweiss Securities Limited. He holds a bachelor's degree of engineering in Chemical Engineering and Post Graduate Diploma in Business Management from Indian Institute of Management (Ahmedabad). Previously, Mr Mittal was associated with the Telecom & Utilities Group of NM Rothschild & Sons in Mumbai.

## Indian broking industry

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The broking industry in India has seen a significant transformation over the past decade or so. The transformation has happened on all the key parameters. Regulatory environment has been a major positive, with a material improvement in disclosures and corporate governance norms. Technological revamp in the stock exchanges suggests that market access has become widespread. Management teams in broking firms are getting increasingly professionalized. This is especially so on the institutional side, with almost all the major marquee international brokers now having a presence in the Indian markets. The depth of participation in the market has also seen a strong increase, with strong growth in institutional participation. Key takeaway is that we believe the equity market structure in India has now acquired a level of maturity.

While structural changes have indeed taken place over the past few years, the industry has undeniably benefited from the bull run in the Indian market. In India, brokers are paid on the basis of the value of the trade. Hence, their business volumes are linked to market levels. So far in FY08, volumes have been exceptionally good, helped by a strong increase in market levels as well as a pick-up in trading velocity. Over the next year, we are building in a moderation in trading volumes growth versus that seen over the past few years. This is primarily on the expectation of only moderate growth in the market levels.

There has been an increase in institutional ownership, largely due to a rise in foreign institutional investors (FII) ownership, in the past few years. A key trend which we expect to pan over the next few years is increasing domestic institutional ownership, on account of a rise in the equity investments of insurance companies.

We outline below some of the key trends and characteristics of the Indian equity markets.

### **Regulatory environment – significant**

Regulatory environment has been a major positive, with a material improvement in disclosures and corporate governance norms.

From a market volume perspective, regulatory action would be most relevant on two key issues:

**Market access to foreign institutions.** The preferred mode of access to the Indian markets of FIIs is through participatory notes (PNs). However, through a notification in October 2007, SEBI, the Indian stock market regulator, had severely curtailed the use of this instrument. Instead, the regulator had asked FIIs to get a direct registration to invest in the Indian markets. From conversations with various market players, it does seem that this action was primarily aimed at channeling FII investment through the direct registration route other than the PN route. However, any move to curtail FII investment into the Indian equity markets so as to manage the foreign flows into the country would be a major negative, in our view.

**Innovation in terms of new products.** The SEBI recently announced the framework for the introduction of short selling in the markets. We would perceive this as a material positive. Note that the lack of short selling opportunities was a major lacuna in the Indian markets.

### **Key regulatory changes in the Indian markets**

**SEBI Act, 1992:** As part of the liberalization process, the Capital Issues (Control) Act of 1947 was repealed in 1992 that paved the way for (SEBI Act, 1992) market-determined resources allocation. Under the new Act, eligible issuers are allowed to issue securities at market-determined rates. The SEBI act exercises control over the market through issuance of guidelines and rules for various capital market activities. It also implements regulations for intermediaries and stock exchanges.

**Screen-Based Trading:** The trading on the stock exchanges of India used to adopt an open outcry system, using no information technology for immediate matching or recording of trades. In order to improve efficiency, liquidity and transparency, nation-wide screen based trading systems were introduced by the NSE and the Stock Exchange, Mumbai, which transformed the Indian capital markets entirely.

**Trading Cycle:** In India, the trading cycle varied between 14 days and 30 days in the past, with settlement usually taking another fortnight. However, after several incidents of defaults and to reduce settlement risk and large open positions, the regulators introduced the T+5 rolling cycle for all scrips across the Indian stock exchanges from December 2001 onwards, which effectively reduced the trading cycle to one day. Thereafter, the regulators continued to shorten the settlement period progressively from T+5 to T+3. Currently, scrips are trade under the T+2 settlement cycle.

**Demutualization (Segregation of Ownership from Management), 2001:** In the past, the stock exchanges in India were owned by brokers, who had a direct control over the operations of the businesses. In March 2001, in order to internationalize the financial markets, the Indian government encouraged the owners of stock exchanges to corporatize, in which ownership, management and trading membership would be segregated from one another. Several exchanges in India have embarked on the demutualization process. In order to speed up the process, the Indian government has offered a variety of tax incentives to facilitate the corporatization.

**Depositories Act, 1996:** In the past, trades were settled by physical movement of papers. The process of physically moving securities among different parties took lengthy time and risked delays. A significant size of transactions ended up as bad delivery due to compliance failure, which added cost to the transactions. In order to minimize settlement risk, the Indian government passed the Depositories Act in 1996. The number of demat (dematerialized account) securities increased to 97.7 bn at the end of March 2004 from 76.9 bn as of end March 2003. All actively traded scrips are held, traded and settled in demat form. Demat settlement accounts for over 99% of turnover settled by delivery. This has almost eliminated the bad deliveries and associated problems. To prevent physical certificates from coming into circulation, the regulators have made it mandatory for all IPOs to be traded in dematerialised form.

**Mutual Funds Regulations:** The Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 govern the law pertaining to the business of mutual funds in India. The SEBI, with a view to improving professional standards, has made it mandatory for all mutual funds to appoint agents/distributors who have obtained certification from the AMFI. In case of firms/companies, the requirement of certification is made applicable to the persons engaged in sales and marketing.

Mutual funds are required to ensure compliance with the guidelines issued by the Association of Mutual Funds in India (AMFI). Intermediaries distributing their products or sub-brokers acting on behalf of such intermediaries have to ensure follow the guidelines, For non-banking financial companies (NBFCs), they can market and distribute mutual fund's products with prior approval of the RBI for an initial period of two years and subject to review thereafter. The NBFCs must, however, comply with certain minimum requirements, such as a minimum net owned fund of Rs1000mn and net profit as per last two years audited balance sheet.

**Insurance Broker Regulations:** The Insurance Act, 1938 ("Insurance Act") embodies the law relating to the business of insurance in India. The Insurance Regulatory and Development Authority (Insurance Brokers) (IRDA) Regulations, 2002, as amended from time to time ("Insurance Broker Regulations") provide inter alia for licensing and capital requirements for persons who are insurance brokers. These regulations require that a company interested in entering the business of dealing in insurance or reinsurance to apply to the IRDA for a license and to follow the 'Code of Conduct for Insurance Brokers'.

**NBFC (Regulations)** According to the RBI Act update, 1999, a company will be treated as an NBFC (a) if its financial assets are more than 50 per cent of its total assets (netted off by intangible assets); and (b) income from financial assets should be more than 50 % of the gross income. Both these requirements are determinant factors for a principal business of a company. The NBFC must also have a net owned fund of INR20 mn with certain exemptions.

Under Section 45-IC of the RBI Act, every NBFC must create a reserve fund and transfer thereto a sum not less than 20 per cent of its net profit every year, as disclosed in the profit and loss account and before any dividend is declared.

**Systemically Important NBFCs-ND (Non-Deposit-Taking):** All NBFCs-ND with an asset size of Rs1bn or more are considered as systemically important NBFCs-ND ("NBFCs-ND-SI"). All NBFCs-ND-SI are required to maintain a minimum capital to risk-weighted assets ratio (CRAR) of 10%. NBFCs-ND-SI are not allowed to: 1) lend to any single borrower exceeding 15% of its owned fund; or any single group of borrowers exceeding 25% of its owned fund; 2) invest in: the shares of another company exceeding 15% of its owned fund; or the shares of a single group of companies exceeding 25% of its owned fund; 3) lend and invest (loans/investments taken together) exceeding 25% of its owned fund to a single party or 40% of its owned fund to a single group of parties.

**KYC Guidelines:** The KYC policies are required to have certain key elements, including inter alia customer acceptance policy, customer identification procedures, monitoring of transactions and risk management, adherence to KYC guidelines and the exercise of due diligence by persons authorized by the NBFC, including its brokers and agents.

**Corporate Governance Guidelines:** All NBFC-ND-SIs are required to adhere to certain corporate governance norms including constitution of an audit committee, a nomination committee, a risk management committee and certain other norms in connection with disclosure and transparency and connected lending.

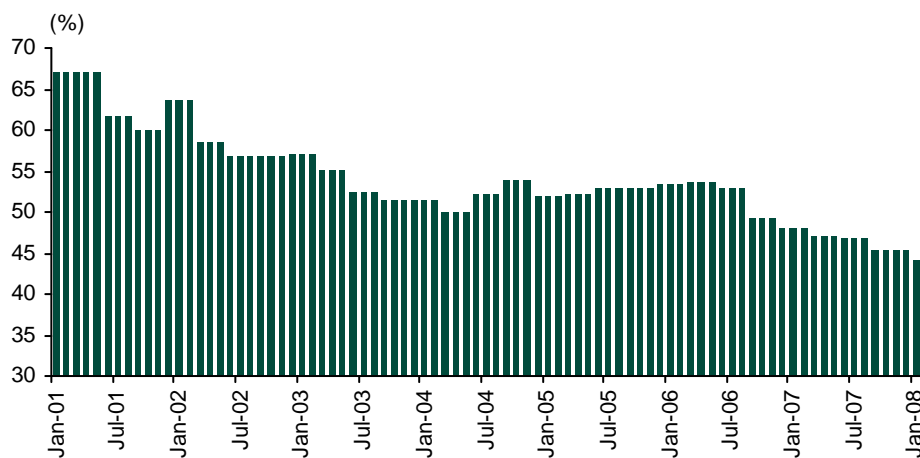
### **Ownership structure – FII have seen the biggest jump; domestics led by insurance could see a similar trend in the future**

The ownership structure of the market is relevant for understanding the market volumes as the trading behaviors of the various classes of participants are markedly different. This is especially so in the Indian context, where the ownership structure is far from being in the steady state.

We highlight three key highlights from an ownership perspective.

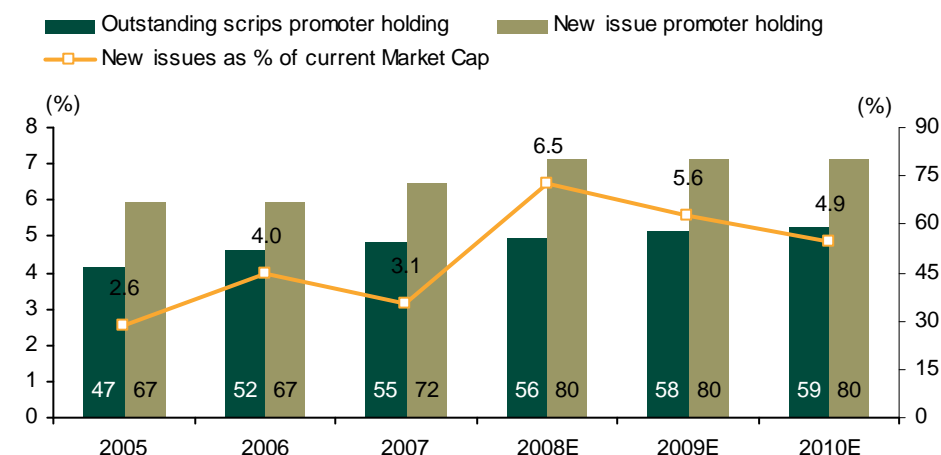
**Increase in promoter holding, even after adjusting for new issues.** (How much of it is due to rights/warrants) There has been a marked increase in promoter holding and thereby a corresponding decline in free float over the past few years. Note that this holds true even after accounting for IPOs.

Figure 23: Movement in free float of BSE 500



Source: BSE, Lehman Brothers estimates

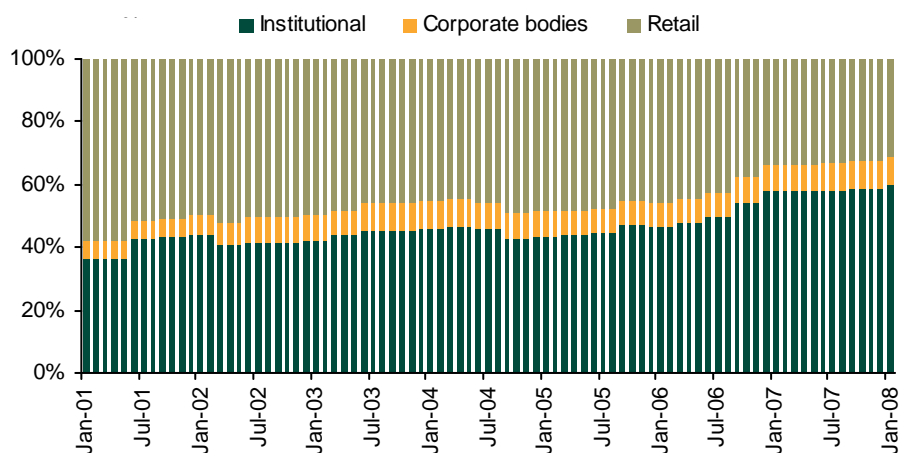
Figure 24: Impact of new issues on promoter holding



Source: BSE, Lehman Brothers estimates

**Material jump in institutional ownership.** In free float, share of institutions has seen a material jump. Increase has been primarily on account of a jump in FII ownership. We highlight that it is retail segment that has seen a decline in ownership. This datapoint is at variance with the popular perception of increasing retail participation, at least in the cash segment.

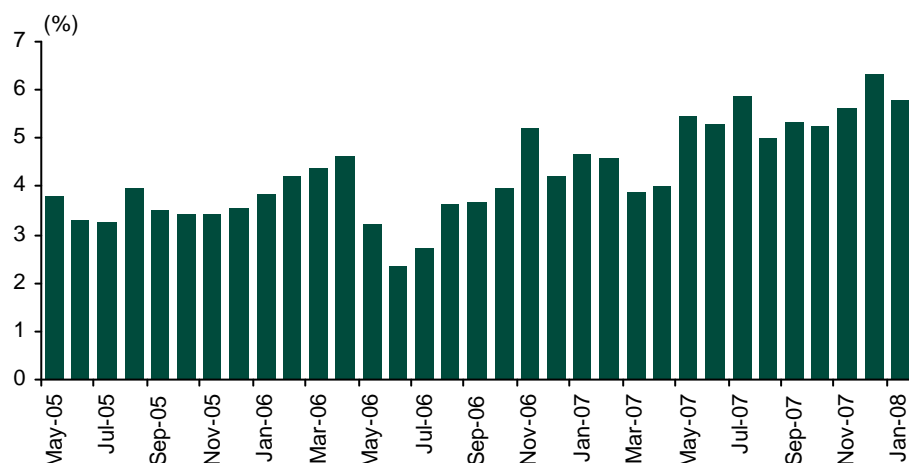
Figure 25: Free float ownership breakdown



Source: BSE, Lehman Brothers estimates

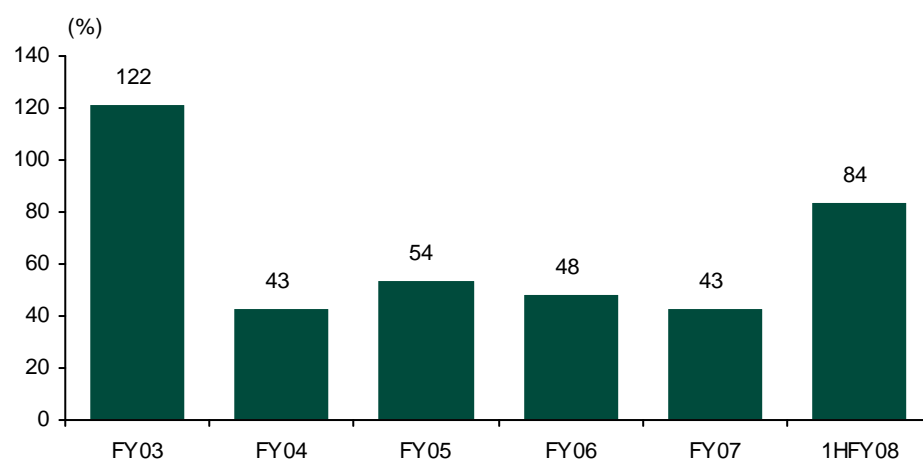
One possible contention could be that a lower retail ownership in the cash segment is probably being offset by a higher retail ownership in the F&O segment (i.e. a higher open interest in the F&O segment as a percentage of market free float) given that retail contributes a large portion of the overall F&O volumes. We, however, find that this does not seem to be the case, reiterating that the retail ownership in listed companies is indeed declining. While the overall markets open interest over the past three years has risen marginally, the percentage to free float is still only around 6%.

Figure 26: Futures (single stocks + index) open interest as % of free float



Source: BSE, Lehman Brothers estimates

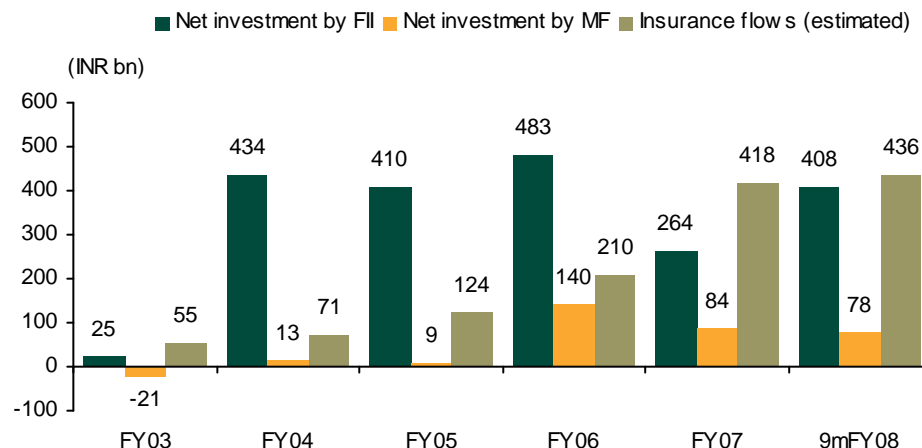
Figure 27: IPO money as % of net FII MF and insurance flows



Source: BSE, Lehman Brothers estimates

**Share of domestics led by insurance set to go up.** We expect a strong spurt in the inflows to domestic institutions, of which the predominant part would be insurance. This should lead to a meaningful rise in their ownership levels.

Figure 28: Net flows into the market from the three institutional sources

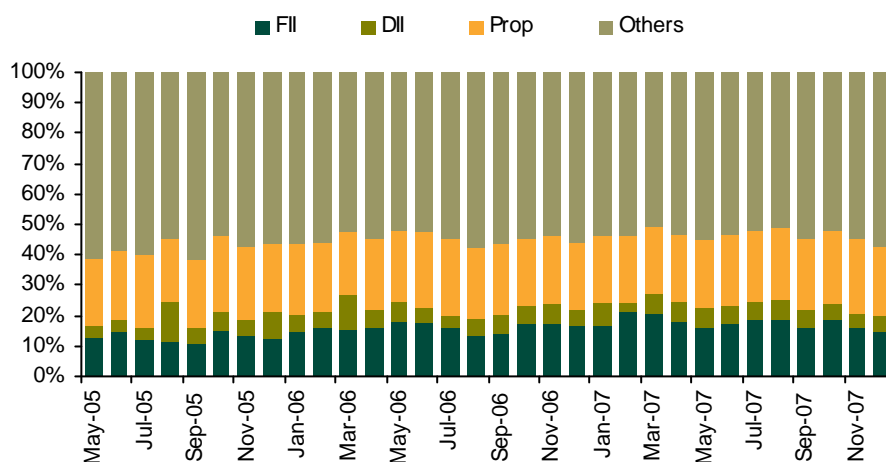


Source: BSE, Lehman Brothers estimates

### Share of institutions in trading volumes has not seen much of a spike in the past three years ...

Investors from a trading volume perspective are categorized into four categories: (1) FIIs; (2) domestic institutions including mutual funds, (3) proprietary trading (done by brokers for their own books); and (4) retail (classified as everybody other than the other three categories). The key observation from an analysis of trading volumes is that the share of these four categories in the overall trading volumes has broadly remained constant over the past three years. We do note that the share of institutions had seen a spike prior to that.

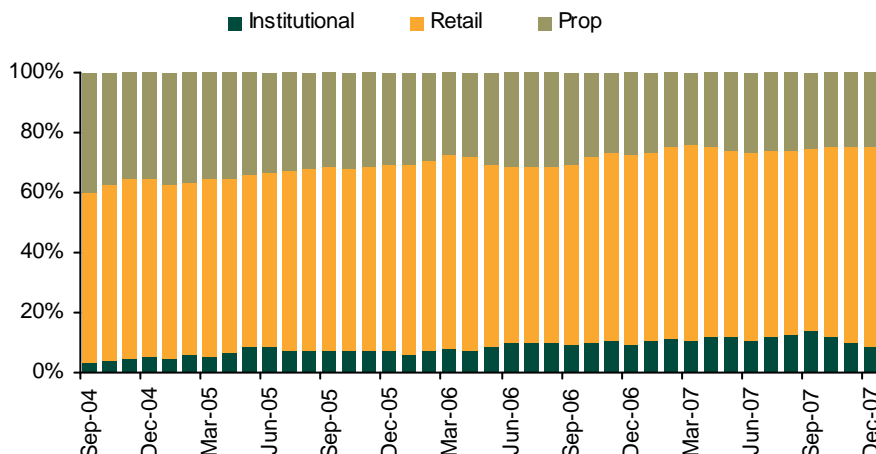
Figure 29: Breakdown of trading volumes in cash segment



Source: BSE, NSE, Lehman Brothers estimates



Figure 30: Breakdown of trading volumes in derivatives segment



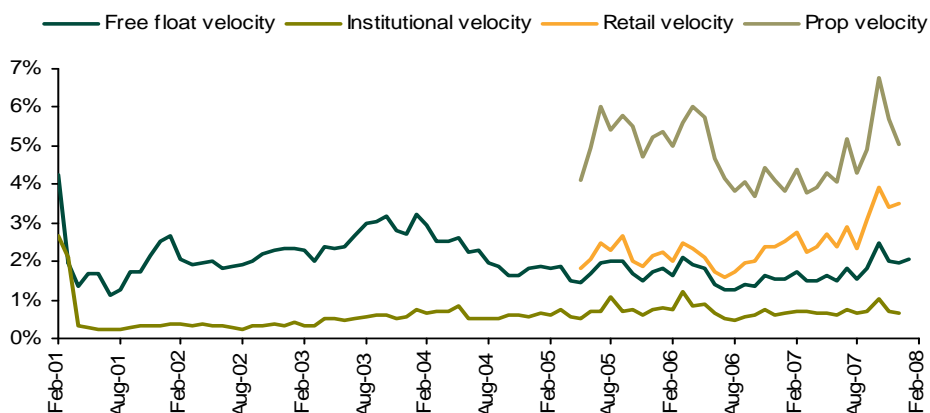
Source: BSE, NSE, Lehman Brothers estimates

### ... as a spike in trading velocity has compensated for lower retail ownership levels

Our analysis indicates that the trading behaviour of the various classes of investors — FIs, domestic institutions, including mutual funds, proprietary trading (done by brokers for their own books) and retail — are markedly different from each other. We measure trading intensity by trading velocity. We define this as trading volume/market cap. This measure normalizes trading volume for market levels. By this measure, the trading velocity of retail is more than double that of institutional investors.

More importantly, trading velocity has seen a spike in the past few months. As a result, while retail ownership has been easing, shares in the overall volumes has broadly remained the same. Also, retail velocity seems to have a strong positive correlation with market's direction; it heads down significantly whenever the market has a sharp correction. On the other hand, institutional velocity has broadly remained the same.

Figure 31: Overall market velocity, as well as velocity of various classes



Source: Lehman Brothers estimates

Figure 32: Relationship between FII and retail velocity



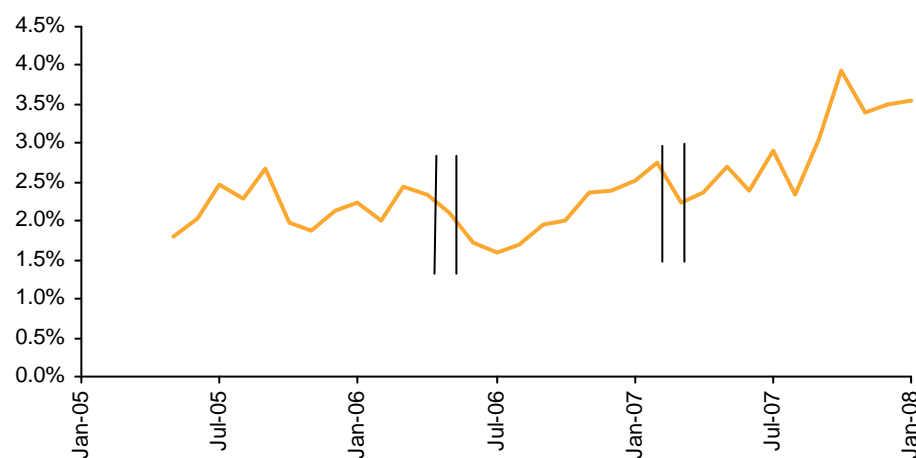
Source: Lehman Brothers estimates

Figure 33: Retail velocity movement with market slowdown

Periods of market correction	Nifty Index MoM returns (%)	Retail & Proprietary trading velocity	
		Preceding 2 months (%)	Next 2 months (%)
Apr-May 04	-17	4.10	3.70
Mar-Apr 05	-10	2.70	2.20
May-06	-14	2.70	2.10
Feb-07	-8	2.90	2.60

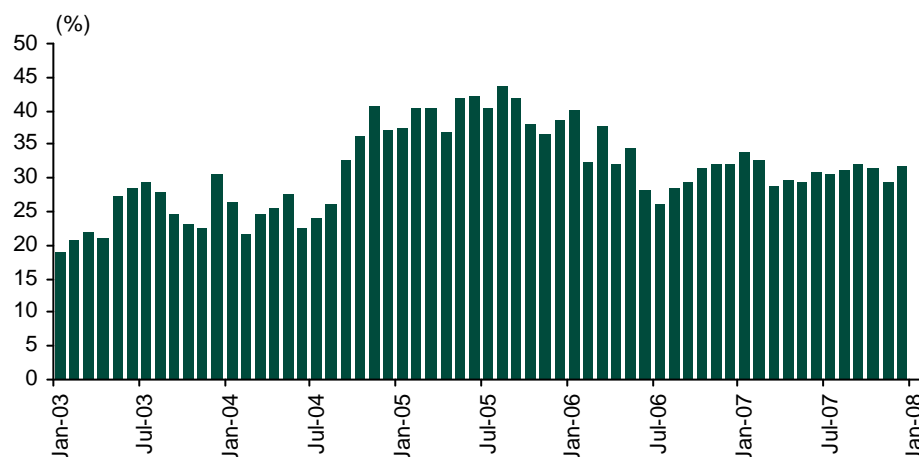
Source: Lehman Brothers estimates

Figure 34: Retail velocity movement with market slowdown\*



Source: Lehman Brothers estimates \*period of Sizeable negative market returns indicated by parallel bars

Figure 35: % of trade in delivery mode



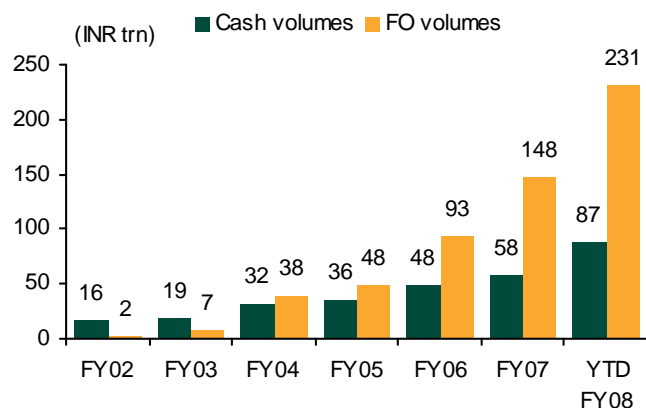
Source: BSE, Lehman Brothers estimates

### Product range: Increasing market breadth; shorts to support volumes

The market currently consists of cash and F&O products. The key highlight from a product perspective has been clearly the impressive rise in the F&O segment over the past few years. A distinctive characteristic of the Indian market is high volumes seen in stock futures. This is in contrast to the other major markets, which are dominated by index futures. So far, F&O volume growth has outstripped that of cash. While we expect F&O volumes to continue to grow faster than that in cash, we expect the differentials in growth to narrow. F&O volume growth was supported by an introduction of new products, both indices and stocks. We expect the pace of introduction of new products to ease. This is particularly so in the stock futures segment, which now occupies 90% of the stocks by market capitalization.

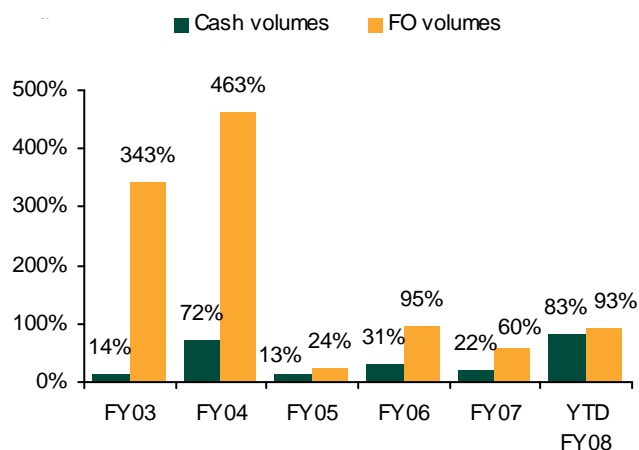
Volume growth, however, may be supported by the introduction of short selling in the markets. Another key volume driver has been on account of the rising market levels. This has led to a significant expansion in the investible universe for institutional investors, thereby supporting volumes.

Figure 36: Cash and futures volumes



Source: NSE, BSE, Lehman Brothers research

Figure 37: Growth in cash and futures volumes



Source: NSE, BSE, Lehman Brothers research

Figure 38: New products introduced in the F&amp;O market

## F&amp;O product

S&P CNX Nifty  
S&P CNX Nifty  
CNX IT  
CNX IT  
BANKEX  
BANKEX  
CNX NIFTY JUNIOR  
CNX NIFTY JUNIOR  
CNX100  
CNX100  
Nifty Midcap 50  
Nifty Midcap 50

## Nature

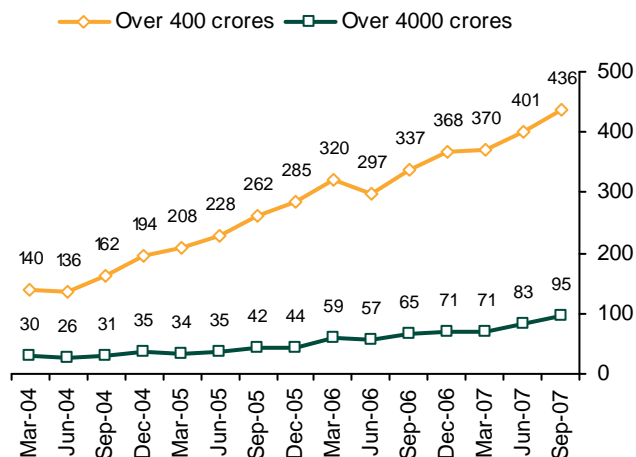
Futures  
Options  
Futures  
Options  
Futures  
Options  
Futures  
Options  
Futures  
Options  
Futures  
Options

## Date

Jun-00  
Jun-01  
Aug-03  
Aug-03  
Jun-05  
Jun-05  
Jun-07  
Jun-07  
Jun-07  
Jun-07  
Oct-07  
Oct-07

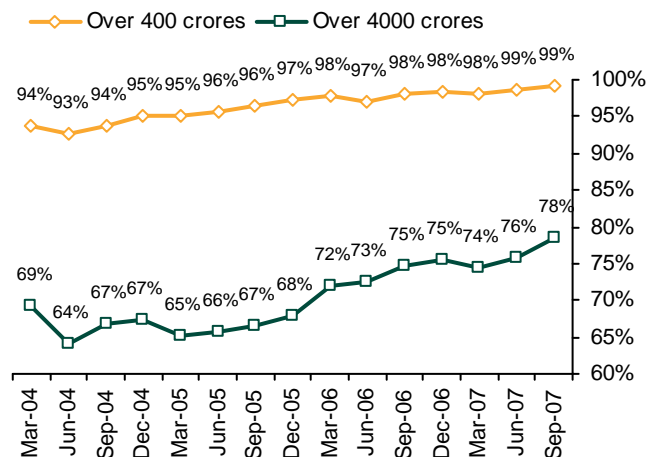
Source: NSE

Figure 39: Companies with free float above threshold...



Source: Lehman Brothers research

Figure 40: ...and as % of overall market cap



Source: Lehman Brothers research

## Broker market share

There is a clear distinction between retail and institutional brokers. Even among firms which conduct both businesses, there is a clear segmentation between these two arms. We expect this distinction to continue as the client requirements for these two classes are vastly different.

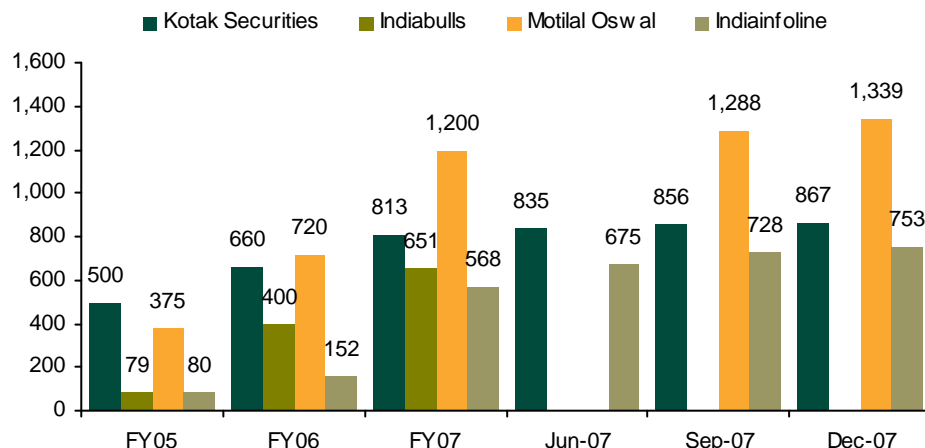
In the institutional segment, there has been a crowding of the market space over the past one year. Quite a new number of foreign players have set up establishments. Also equally importantly is that domestic players have significantly beefed up their operations. Employee stock ownership plans (ESOPs) have become the favored route for domestic players to attract talent. As a result, we believe that the competitive intensity in the space has increased. A key takeaway is that we do not expect any material change in the market shares of the already established players.

**Figure 41: New entrants in the institutional broking market**

Players exiting JVs	Year	Ex-partner
Goldman Sachs	2006	Kotak
Morgan Stanley	2007	JM Financial
<b>New entrants</b>		
Lehman Brothers	2007	
India Infoline	2007	
Tata Securities	Planned entry	
Macquarie Securities	2006	
Almondz Capital	2006	
Prime Broking	2006	
Centrum Broking	2006	
SBICap Securities	2006	
Ambit Securities broking	2005	
Other deals	Nature	Target
JM Financial	Stake acquisition	ASK Securities
IDFC	Stake acquisition	SSKI
BNP Paribas	Stake acquisition	Geojit Financial

Source: BSE, Lehman Brothers estimates

Figure 42: Distribution networks of retail brokers



Source: BSE, Lehman Brothers estimates

### Modeling market volumes

In India, brokerage commissions paid are linked to the value of the trade. Consequently, modeling brokerage revenues is a function of the value of traded volumes. Note that in some of the other markets, commission is paid on a per share basis. In such a market, brokerage commissions are not directly linked to the market levels.

We model overall market volumes based on three parameters as follows.

**Overall market capitalization.** With commission paid linked to the value of the trade, the market capitalization of free float is an obvious parameter to determine trading volumes. Overall market capitalization is then determined by the market levels as well as new issues added during the period.

We have assumed that new issues will add c.6% to the current market cap. This is broadly in line with the trend seen in the past two years. Regarding overall market capitalization growth, we have assumed uniform 1.1% MoM growth, translating into 14% annual growth over the next two years.

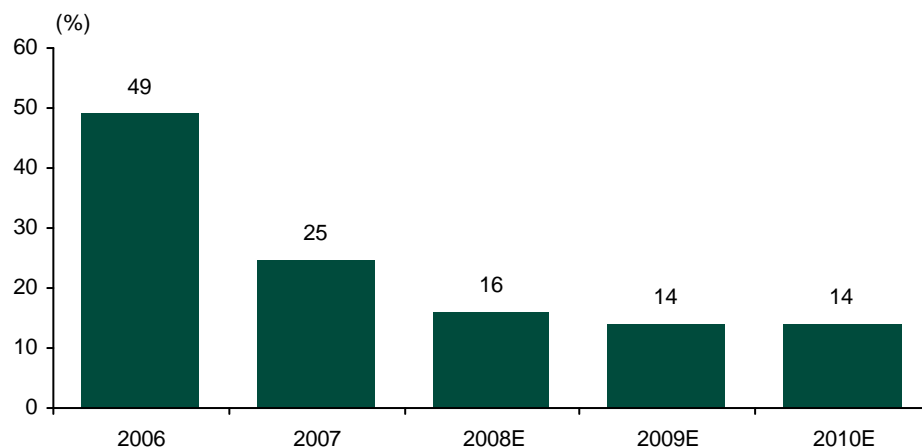
We do recognize that projecting growth in market levels is not easy. Hence, what is of more relevance than absolute market level growth is the sensitivity to changes in volumes under various scenarios for the market levels. We discuss this below.

Figure 43: New issues that have been added

INR bn	Free float added	As % existing free float (%)	Market cap added	As % existing market cap
2005	355	3.4	635	3.2
2006	578	3.7	1434	4.7
2007	589	2.7	2238	4.7

Source: Bloomberg, Lehman Brothers estimates

Figure 44: Assumptions on market level growth



Source: NSE, Lehman Brothers estimates

**Trading velocity.** Another key input to overall volumes is the trading velocity. As discussed earlier, trading velocity of the different classes of investors is markedly different. Not only is it different in absolute terms, the sensitivity to the direction of market is also different. While institutional velocity seems broadly stable, retail velocity is volatile with market direction.

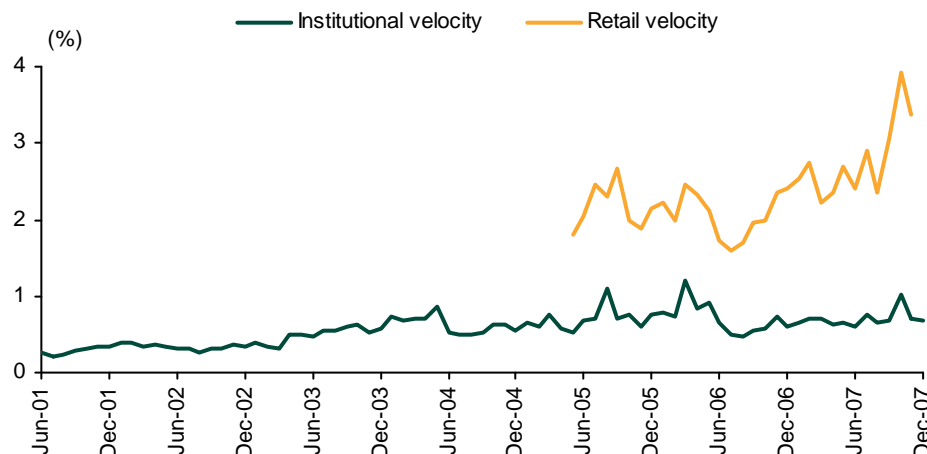
**Ownership levels.** The degree of ownership of the various classes of investors has a material impact on the overall market volumes, on account of their differing trading behavior. In our base case, we are building in a further increase in institutional ownership. Implicitly, we are thus assuming an increase in institutional volumes.

**Sensitivity to market levels.** We believe that analyzing the sensitivity of volume changes to market levels is the key to understanding this segment. Such an analysis not only gives a sense of trading volumes in various scenarios, but also shows the risk inherent in the sector.

We believe that the sensitivity of trading volumes to the direction of market levels would play out through two key parameters:

**Impact on trading velocity.** The intuitive and qualitative rule is that trading velocity would rise when markets are ebullient, as speculators emerge and vice-versa. An analysis of the data shows that this is indeed the case for retail investors. For institutional investors, trading velocity seems fairly stable. The table below is assumptions for trading velocity for the various classes of investors under various scenarios for market levels.

Figure 45: Retail and institutional velocities historically



Source: Lehman Brothers estimates

**Impact on institutional flows and their consequent impact on ownership levels.** We believe that this is a very critical factor, which not only has an impact on ownership but also on market levels.

We highlight two scenarios. Under the first scenario, institutional flows continue to be strong. Such a scenario would suggest that the market continues to enjoy a very strong bull run. Otherwise, the ownership levels in the non-institutional category would have to fall to absurd levels. A strong bull market would in turn imply that retail trading velocity would be strong.

Under the second scenario, we model in a sharp fall in foreign flows, as well as moderate decline in domestic flows. Note that in this scenario, we are modeling in an increase in insurance lapse rates, but this will still translate into year-on-year growth in flows from the insurance sector. Under such a scenario, we would be building in a much more modest growth rates in the market levels.

Two key takeaways from our scenario analysis are as follows.

- Retail ownership levels are coming down under both the bull and bear scenarios. This should clearly have an impact on their volumes
- Sensitivity of overall volumes to market levels is indeed high.



## Financial tables

Figure 46: Income statement

(INR mn)	FY05	FY06	FY07	FY08E	FY09E	FY10E
Fee, brokerage and commission income	424	993	2,154	2,937	6,641	8,859
Trading and arbitrage income	213	447	1,142	2,927	4,477	4,477
Investment and dividend income	112	104	265	970	970	970
Interest income	13	26	129	1,390	2,475	4,875
Other income	8	10	23	0	0	0
Total income	770	1,580	3,713	9,475	14,563	19,180
Total expenses	(423)	(885)	(1,975)	(5,814)	(8,921)	(11,887)
Employee expenses	(183)	(346)	(817)	(1,926)	(2,697)	(3,371)
Administrative expenses	(196)	(465)	(933)	(1,866)	(3,635)	(4,345)
Depreciation	(10)	(21)	(38)	(57)	(74)	(96)
Financial expenses	(34)	(54)	(187)	(1,965)	(2,516)	(4,075)
Pre-tax income	347	695	1,738	3,660	5,642	7,294
Tax provided	(113)	(230)	(646)	(1,281)	(1,975)	(2,553)
Profit before minorities	234	444	1,092	2,379	3,667	4,741
Minorities	(9)	(38)	(2)	(95)	(147)	(190)
Net profit	225	405	1,090	2,609	3,521	4,551

Source: Company data, Lehman Brothers estimates

Figure 47: Balance sheet

(INR mn)	FY05	FY06	FY07	FY08E	FY09E	FY10E
Cash				1,500	2,000	2,000
F&O margin – working capital requirements				6,443	8,732	10,623
Trading and arbitrage book				22,384	22,384	22,384
ECL financing				8,000	25,000	40,000
Other misc. business expenses				1,400	1,610	1,852
Fixed assets				272	408	531
Total assets	1,162	3,511	12,687	40,000	60,134	77,390
<u>As reported</u>						
Investments	102	324	824			
Current assets, loans and advances	1,017	3,116	11,682			
Stock-in-trade	271	1,405	5,756			
Sundry debtors	122	364	583			
Cash and bank balances	120	637	2,651			
Other current assets	3	10	75			
Fixed assets	500	700	2,616			
Deferred tax assets	41	67	170			
Short-term liabilities	120	505	3,870	15,081	31,000	45,000
long-term liabilities	404	1,173	1,462	1,839	2,391	3,108
Other liabilities	36	45	134	1,000	1,500	2,250
Total liabilities	560	1,723	5,465	16,920	34,891	50,358
Share capital	29	38	50	375	375	375
Stock options	14	25	36	41	41	41
Reserves	497	1,721	5,737	17,228	19,703	22,903
Net worth	539	1,784	5,823	17,643	20,118	23,319
Minorities	62	3	1,399	5,270	5,270	5,270
Total equity and liabilities	1,162	3,511	12,687	40,000	60,134	77,390

Source: Company data, Lehman Brothers estimates

**Figure 48: Growth ratios**

(%)	FY06	FY07	FY08E	FY09E	FY10E
Revenue growth	105	135	155	54	32
Expenses growth	109	123	194	53	33
Operating profit growth	90	136	136	40	25
Net profit growth	80	169	139	35	29
EPS growth	49	126	56	35	29
BVPS growth	173	175	97	14	16

Source: Company data, Lehman Brothers estimates

**Figure 49: Profitability**

(%)	FY05	FY06	FY07	FY08E	FY09E	FY10E
RoE	55.6	40.0	28.7	20.3	19.4	21.8
RoA	23.9	19.9	13.5	9.0	7.3	6.9

Source: Company data, Lehman Brothers estimates

**Figure 50: Per share data**

(INR)	FY05	FY06	FY07	FY08E	FY09E	FY10E
EPS	6.1	9.1	20.6	32.1	43.2	55.9
DPS	0.1	0.1	0.0	7.3	11.3	14.6
BVPS	15	40	110	217	247	286

Source: Company data, Lehman Brothers estimates

**Figure 51: Valuations**

INR	FY05	FY06	FY07	FY08E	FY09E	FY10E
P/E	110.2	73.9	32.6	20.9	15.5	12.0
P/BV	45.9	16.8	6.1	3.1	2.7	2.3
Dividend yield	0.0	0.0	0.0	1.1	1.7	2.2

Source: Company data, Lehman Brothers estimates

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**Edelweiss Capital Ltd (EDEL.NS)****INR 676.15 (14-Mar-2008)****1-Overweight / 1-Positive**

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We value the two balance sheet based businesses: trading and arbitrage and wholesale finance, on a P/BV basis. We value the wholesale finance at 3.9x FY09BV. We believe that this is a very interesting business area with Edelweiss enjoying a first mover advantage as well as synergies from existing businesses. The trading and arbitrage business, however, has been valued at 1.1x FY09E invested capital in that business. The lower multiple is to reflect the inherently opaque nature of the business.

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**JPY 1478 (14-Mar-2008)**

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<b>Related Stocks</b>	<b>Ticker</b>	<b>Price (14-Mar-2008)</b>	<b>Stock / Sector Rating</b>
CITIC Securities Co., Ltd.	600030.SS	CNY 57.99	1-Overweight / 1-Positive
Daiwa Securities Group Inc	8601.T	JPY 872	1-Overweight / 1-Positive
Nomura Holdings Inc	8604.T	JPY 1478	1-Overweight / 1-Positive

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### Hong Kong

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### Mumbai

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