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Reliance Industries: Downside risks persist

Sun Pharmaceuticals: Deal with FRX is positive for sentiment

Economy: IIP starts the climb up the hill with 2.7% growth in May

Automobiles: Monthly tracker - July 2009

News Round-up

- The Tatas-owned Jaguar Land Rover (JLR) plans an extended shut down of its UK plants and a new round of staff layoffs as it struggles to cope up with the slump in the world car market (BS)
- Sterlite Energy, a wholly-owned subsidiary of Vedanta Group firm Sterlite Industries, may hit the capital market soon with a public offering to raise up to Rs3,000 crore to part finance its expansion plans (BS)
- State-run National Aviation Co. of India Ltd, or Nacil, the operator of Air India, is raising about \$1 billion (around Rs4,870 crore) in the form of an 11-year loan from US bank JPMorgan Chase and Co. to fund a part of its ambitious fleet expansion exercise (Mint)
- After the initial wave, Qualified Institutional Placements (QIP) are expected to pause as SEBI has rejected proposals made by investment bankers to relax the pricing formula for such issues. (BS)
- Amidst concerns over possible rise in interest rates due to the huge government borrowing programme, Finance Minister Pranab Mukherjee today reassured that interest rates would not rise in the next few months (BS)
- Areva, the French nuclear reactor maker, is broadening its business plan for India with major investments in its strategic joint ventures with Bharat Forge, Tata Group, Bharat Heavy Electricals (BHEL) and Nuclear Power Corporation of India (NPCIL), though it is exiting from the power transmission and distribution (T&D) business in the country (BS)
- Petroleum Minister Murli Deora today asserted that the KG basin gas belongs to the government and not to either of the Ambani brothers, Mukesh and Anil, who have taken the battle to court (Financial Express)
- Japanese brokerage house Nomura Holdings Inc. agreed to buy a 35% stake in LIC Mutual Fund, to expand sales in Asia's third largest economy. Nomura will pay around 6 billion yen (around Rs316.5 crore) for the holding in LIC Mutual Fund Asset Management Co. Ltd (Mint)
- Power Grid Corporation of India Ltd, which has charted out a capex of Rs 55,000 crore during the XI Plan period, is considering a domestic bond offer to part fund its expansion (Business Line)
- Alstom Projects India Ltd (APIL) announced that it has been awarded the Rs 265 crore project of Lanco Infratech Ltd for installation of a new power plant on Teesta River in Sikkim (Business Line)Text

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

EQUITY MARKETS

India	Change %		
	10-Jul	1-day	1-mo
Sensex	13,504	(1.8)	(11.4)
Nifty	4,004	(1.9)	(12.6)
Global/Regional indices			
Dow Jones	8,147	(0.4)	(7.4)
Nasdaq Composite	1,756	0.2	(5.5)
FTSE	4,127	(0.8)	(7.1)
Nikkie	9,298	0.1	(8.3)
Hang Seng	17,708	(0.5)	(6.3)
KOSPI	1,420	(0.6)	(0.6)
Value traded - India			
Cash (NSE+BSE)	194.6	259.7	256.2
Derivatives (NSE)	578.9	733.6	630
Deri. open interest	739.7	840	787

Forex/money market

	Change, basis points			
	10-Jul	1-day	1-mo	3-mo
Rs/US\$	49.0	24	169	(106)
10yr govt bond, %	7.0	3	26	28
Net investment (US\$m)				
	9-Jul		MTD	CYTD
FII	(60)		740	5,710
MF	53		(96)	425

Top movers -3mo basis

	Change, %			
	10-Jul	1-day	1-mo	3-mo
Best performers				
MTNL IN Equity	88	(2.6)	(19.4)	17.9
BJAUT IN Equity	1,015	1.4	0.8	67.7
HPCL IN Equity	322	(3.7)	5.9	26.9
GMRI IN Equity	125	(2.9)	(21.4)	17.5
INFO IN Equity	1,721	2.6	(0.4)	22.1
Worst performers				
NACL IN Equity	273	(3.0)	(24.8)	10.8
DIVI IN Equity	999	(1.9)	(15.1)	8.9
HDFCB IN Equity	1,379	(1.5)	(9.8)	25.5
WPRO IN Equity	385	3.1	(6.2)	43.2
ABB IN Equity	692	(3.2)	(8.9)	39.9

JULY 13, 2009

RESULT

Coverage view: **Attractive**

Price (Rs): **1,721**

Target price (Rs): **1,900**

BSE-30: **13,504**

Excessively conservative guidance. Infosys reported strong performance for the June 2009 quarter, exceeding our expectations and that of consensus in terms of revenue, EBITDA and net income. At the risk of sounding cliché, we believe that FY2010E guidance is excessively conservative and leaves room for significant outperformance. Improvement in decision making, lower project cancellations, and new deal wins will drive growth and positive surprises over the next 12-month. Retain BUY.

Company data and valuation summary

Infosys Technologies

Stock data				Forecasts/Valuations			
52-week range (Rs) (high,low)				2009			
2,070-1,040				2010E			
Market Cap. (Rs bn)				2011E			
987.9				EPS (Rs)			
Shareholding pattern (%)				29.6			
Promoters				0.1			
FII				10.1			
MFs				P/E (X)			
3.6				16.8			
Price performance (%)				216.9			
1M				224.6			
3M				259.1			
12M				58.8			
Absolute				58.8			
(0.4)				64.8			
22.1				72.0			
2.6				72.6			
9.8				12.2			
(0.8)				11.5			
2.4				9.7			
9.8				36.7			
(0.8)				28.9			
2.4				26.3			
9.8				1.4			
(0.8)				1.5			
2.4				1.9			

Valuations—we assign a multiple of 17X FY2011E earnings

We value Infosys at near its peak cycle multiple of 17X FY2011E earnings and raise our target price to Rs1,900/share. We believe the stock could move to peak cycle multiple driven by acceleration in revenue growth and consensus upgrades. Exhibit 1 details the underlying rationale for our mid-cycle multiple. At 17X, the stock implies 3-4 years of reasonable 15% growth followed by growth rates trending down to 6%. Infosys stock currently implies FCF-to-perpetuity of 6.5% assuming FY2010E as the terminal year and adjusting the earnings for a potential increase in tax rates.

FY2010E revenue guidance is conservative; expect significant outperformance

We view Infosys' unchanged FY2010E US\$ revenue guidance at the upper end to be excessively conservative. Infosys outperformed the upper end of its 1QFY10 US\$ revenue guidance by 3.8% (2% cross-currency benefit and 1.8% core business outperformance). The revised guidance implies flat revenues for the remaining quarters of FY2010E. However, our channel checks indicate (1) significant improvement and business flow in new clients wins; (2) lower project cancellations; (3) improved pace of consolidation and new deal wins in relatively under-penetrated verticals. We increase our FY2010E revenue estimate and now model flat US\$ revenues yoy versus the company's guidance of 4.6% decline in revenues.

Revised EPS guidance is even more conservative

We find Infosys' revised EPS guidance of Rs94.6-96 overly cautious and conservative. We revise our FY2010E EPS to Rs102.5 (versus Rs99.3 earlier) and FY2011E EPS to Rs112.8 (versus Rs111.9 earlier). Our higher-than-company-guidance EPS estimate for FY2010E is largely driven by our higher revenue forecast and our view on stable operating margins (after adjusting for forex losses of FY2009 above the EBITDA line). Infosys' 1QFY10 and FY2009 operating margins were 34.1% and 33.2%, respectively. We do not see incremental margin pressures in 2Q-4QFY10E apart from the company's planned investments on sales and marketing. Pricing pressure, a key source of margin pressure, has eased in mid-sized deals but continues to be high for large deals --this is consistent with our expectations and built into our model. We forecast a 90 bps decline in FY2010E OPM versus the company's guidance of 150 bps.

QUICK NUMBERS

- Beats upper-end of constant currency revenue guidance by 1.7%
- Sequential margin expansion of 50 bps despite Re pressure a positive surprise
- Telecom vertical revenues up qoq despite US\$13 mn revenue decline in the BT account

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FY2010E EPS guidance reduced to Rs96 from Rs101.2 earlier (Re/US\$ now 47.9)

Infosys has reduced FY2010E EPS guidance to Rs94.6-96, versus Rs96.7-101.2 earlier. This decline is led by (1) revision in Re/US\$ rate to Rs47.9 versus Rs50.72 earlier and (2) increase in tax rate assumption to 19-20% versus 16.5-17% earlier—the company is attributing this to slower-than-expected ramp up from SEZs. The guidance now assumes lower OPM decline of 150 bps versus 300 bps earlier.

In our view, the key concern area for the street would be unchanged US\$ revenue guidance (upper end) for FY2010E despite favorable cross-currency movement (2%) and outperformance of the 1Q guidance (1.8%). The guidance assumes flat revenues for the remaining three quarters of FY2010E. Revenue guidance for September 2009 quarter also assumes flat revenues—the company attributes this to continued uncertainty in the external environment. In our view, the company appears to have taken a cautious stance given that deal signings, decision making and closure of vendor consolidation deals have improved significantly.

Solid June 2009 quarter performance

Infosys' 1QFY10 results were better than our expectations on all counts viz revenues, EBITDA and net income –

- ▶ Revenues of US\$1.12 bn (flat qoq and down 3% yoy) was 3.9% ahead of the upper end of its guidance of US\$1.06-1.08 bn. In constant currency terms, revenues at US\$1,098 mn beat the upper end of the guidance, after two quarters of underperformance.
- ▶ EBITDA at Rs18.68 bn (down 1.2% qoq, up 26.3% yoy) was 12.5% higher than our expectation of Rs16.6 bn. EBITDA margin at 34.1% was up 50 bps qoq and 360 bps yoy was above our expectation of 31%. The margin surprise was led by positive surprise on onsite price realization (up 2.6% on reported and 0.6% qoq on constant currency basis) and delayed reinvestment of excess margins in sales and marketing.
- ▶ Reported net income of Rs15.27 bn was 10% ahead of our estimates. Positive surprise largely flowed through from better-than-expected EBITDA performance and moderate positive variance on forex income. Net profit number absorbed the entire increase in taxation resulting on expiry of tax benefits for its STPI units (having completed 10 years).

Several qualitative positives in 1QFY10 results

We highlight several positives in the Infosys' 1QFY10 results

- ▶ **Revenue decline contained despite severe pressure from BT relationship.** BT revenues declined 21% qoq and 23% yoy to GBP 35.3 mn; BT revenues are now down 40% from a peak of GBP59 mn billing in the March 2008 quarter. We are impressed with the company's ability to manage such large shocks. We note that revenues from the BT account have declined on account of decline in BT's core IT budget, loss of existing client revenues (lost to upfront payment deals of Tech Mahindra) and potentially to unreasonable demand on pricing concessions.
- ▶ **Revenues from new clients.** Revenue from new clients was a healthy US\$14.6 mn (1.3% of revenues) versus US\$4.6 mn (0.4%) in 1QFY09 and US\$4.6 mn (0.5%) in 1QFY08 (see Exhibit 2). In the current quarter the company announced three large contracts and three transformational deals.

- **Client metrics improving, other metrics steady.** Infosys added reasonable list of accounts to the high potential US\$10-30 mn bracket. Revenues from different vertical painted a steady picture. Application management revenues increased 7% sequentially reflecting buoyancy and market share gains in 'run the business' services.

No more overhang of tax increase left for FY2011E

Infosys' tax rates will increase to ~19-20% for FY2010E from 14.9% in the previous year. Infosys' major STPI units completed maximum 10 yrs of tax benefit at the end of FY2009. Exhibit 5 lists STPI units in which tax benefits has expired and the ones with tax exemption is still available. In addition Infosys' Chennai SEZ also moved from 100% tax exemption status to 50% starting FY2010E. As a result, the company will not have major overhang of tax increase in FY2011E; tax rates in future years will move in 20-22% range after a potential jump to 23% in FY2011E.

Exhibit 1: Implied PE multiple under various assumption sets using two-stage DDM

	High-growth phase				Steady-state phase			Implied PE (X)
	Length (years)	Growth rate (%)	Payout ratio (%)	Implied ROE (%)	Growth rate (%)	Payout ratio (%)	Implied ROE (%)	
Scenario 1	4	10	50	20	6	80	30	14.7
Scenario 2	5	10	50	20	6	80	30	14.8
Scenario 3	6	10	50	20	6	80	30	14.9
Scenario 4	7	10	50	20	6	80	30	15.1
Scenario 5	4	15	50	30	6	80	30	17.4
Scenario 6	5	15	50	30	6	80	30	18.3
Scenario 7	6	15	50	30	6	80	30	19.2
Scenario 8	7	15	50	30	6	80	30	20.1
Scenario 9	4	20	50	40	6	80	30	20.5
Scenario 10	5	20	50	40	6	80	30	22.4
Scenario 11	6	20	50	40	6	80	30	24.5
Scenario 12	7	20	50	40	6	80	30	26.6

Note:

(a) Payout ratio refers to dividend payout ratio.

(b) Implied ROE = retention ratio/growth rate; retention ratio = 1 - payout ratio.

(c) Cost of equity taken as 12%.

Source: Kotak Institutional Equities

Exhibit 2: Quantum of new business improved significantly in the June 2009 quarter

	FY2008				FY2009				FY2010
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q
Revenues (US\$ mn)	928	1,022	1,084	1,142	1,155	1,216	1,171	1,122	1,122
Repeat business (%)	99.5	97.7	96.3	95.0	99.6	99.8	97.1	95.9	98.7
Revenues from new clients (US\$ mn)	4.6	23.5	40.1	57.1	4.6	2.4	34.0	46.0	14.6
New clients added (#)	35	48	47	40	49	40	30	37	27
Cumulative new clients in the fiscal (#)	35	83	130	170	49	89	119	156	27
Annualized revenue per new client (US\$ mn)	1.1	1.6	1.5	1.5	0.8	0.1	1.3	1.3	4.3

Note:

(1) We assume no churn in the new clients added during a year in the same year.

Source: Company, Kotak Institutional Equities

Exhibit 3: Infosys Interim Results (consolidated Indian GAAP)

Rs mn	1QFY09	4QFY09	1QFY10	% chg.		Deviation from Kotak estimates		Comments
				qoq	yoy	1QFY10	% chg.	
Revenues	48,540	56,350	54,720	(2.9)	12.7	53,876	1.6	estimate of 1,107 mn. Volumes declined 1%, while blended pricing went up 1.04%, driven by cross-currency benefits
Software Development Costs	(27,540)	(30,450)	(29,150)	(4.3)	5.8	(30,373)	(4.0)	
Gross profit	21,000	25,900	25,570	(1.3)	21.8	23,503	8.8	
Selling and marketing exp	(2,570)	(2,700)	(2,610)	(3.3)	1.6	(2,852)	(8.5)	
Administration exp	(3,640)	(4,290)	(4,280)	(0.2)	17.6	(4,045)	5.8	
Total SG&A Expenses	(6,210)	(6,990)	(6,890)	(1.4)	11.0	(6,897)	(0.1)	
EBITDA	14,790	18,910	18,680	(1.2)	26.3	16,606	12.5	Margin expansion (50 bps qoq and 360 bps yoy) defied expectations. Margin headwinds in the form of Rupee depreciation, utilization drop, etc. was met by aggressive cost control on employee and S&M costs.
Depreciation	(1,690)	(2,280)	(2,220)	(2.6)	31.4	(1,973)	12.5	
EBIT	13,100	16,630	16,460	(1.0)	25.6	14,633	12.5	
Interest	-	-	-	-	-	-	-	
Other Income	1,170	2,520	2,690	7	129.9	2,027	32.7	
Provision for investments	-	-	-	-	-	-	-	
Profit Before Tax	14,270	19,150	19,150	-	34.2	16,661	14.9	
Provision for Tax	(1,560)	(3,170)	(3,880)	22.4	148.7	(2,824)	37.4	Effective tax rate of 20.3% significantly ahead of our and street expectations
Net Profit	12,710	15,980	15,270	(4.4)	20.1	13,837	10.4	
Minority Interest	-	-	-	-	-	-	-	
Extraordinaries	310	150	-	-	-	-	-	
Net Profit- Reported	13,020	16,130	15,270	(5.3)	17.3	13,837	10.4	
EPS (Rs/ share)	22.1	27.8	26.6	(4.4)	20.1	24.1	10.4	
No of shares outstanding (mn)	574.0	574.0	574.0	-	-	574.0	-	
As % of revenues								
Gross Profit Margin (%)	43.3	46.0	46.7			43.6		
Operating Margin	30.5	33.6	34.1			30.8		
Selling Expenses	5.3	4.8	4.8			5.3		
Admin Expenses (%)	7.5	7.6	7.8			7.5		
SG&A Expenses (%)	12.8	12.4	12.6			12.8		
Tax rate	10.9	16.6	20.3					
Billing Rates (US\$/annum)								
Onsite	147,497	137,033	140,616	2.6	(4.7)			
Offshore	60,722	55,621	55,653	0.1	(8.3)			
Volumes growth	0.8	(1.6)	(1.0)			(1.4)		
Revenue Mix (%)								
Onsite	50.5	51.1	51.4					
Offshore	49.5	48.9	48.6					
Total Employees	94,379	104,850	103,905	(1)	10.1			
Guidance (consolidated)	2QFY10		FY2010					
	Lower end	Upper end	Lower end	Upper end				
Revenues (Rs bn)	53.18	54.1	214.2	217.5	Lower-end of the US\$ revenue guidance for FY2010E raised to US\$4.45 bn (decline of 4.6%) from US\$4.35 bn (decline of 6.7%)			
Growth (%)	(2.8)	(1.1)	(1.3)	0.3				
Revenues (US\$ mn)	1110	1130	4,450	4,520				
Growth (%)	(1.1)	0.7	(4.6)	(3.1)				
EPS (a)	23.67	24.09	94.6	96.0	Re EPS guidance for FY2010E reduced to RS96 from Rs101.2 at the upper-end			
Growth (%)	(11.1)	(9.5)	(9.6)	(8.2)				
Guidance based on Re/ US\$ rate of 50.72								

Source: Company, Kotak Institutional Equities estimates

Exhibit 4: Key changes to estimates, March fiscal year-ends, 2010E-2011E (Rs mn)

	New		Old		Change (%)	
	2010E	2011E	2010E	2011E	2010E	2011E
Revenues	224,584	259,090	221,078	256,091	1.6	1.2
EBITDA	72,578	82,472	68,074	78,241	6.6	5.4
Depreciation	(9,204)	(9,928)	(8,354)	(9,150)	10.2	8.5
EBIT	63,375	72,544	59,719	69,091	6.1	5.0
Net Profit	58,842	64,764	57,005	64,244	3.2	0.8
EPS (Rs/ share)	102.5	112.8	99.3	111.9	3.2	0.8
Revenues (US\$ mn)	4,676	5,421	4,604	5,360	1.6	1.1
Revenue growth (%)	0.2	15.9	(1.3)	16.4		
Volume Growth (%)	6.3	16.7	7.2	17.8		
Billing Rates (US\$/ manmonth)						
Onsite	11,583	11,557	11,274	11,190	2.7	3.3
Offshore	4,566	4,580	4,517	4,484	1.1	2.1
Margins (%)						
EBITDA	32.3	31.8	30.8	30.6		
EBIT	28.2	28.0	27.0	27.0		
Rs/ US\$ rate	48.0	47.8	48.0	47.8	0.0	0.0

Source: Kotak Institutional Equities estimates

Exhibit 5: Infosys' STPI units and their tax exemption status

Unit	Year of Commencement	Tax exemption status
Electronics City, Bangalore	1995	Expired
Mangalore	1996	Expired
Pune	1997	Expired
Bhubaneswar	1997	Expired
Chennai	1997	Expired
Phase I, Electronics City, Bangalore	1999	Expired
Phase II, Electronics City, Bangalore	2000	Ends FY2009
Hinjewadi, Pune	2000	Ends FY2009
Mysore	2000	Ends FY2009
Hyderabad	2000	Ends FY2009
Mohali	2000	Ends FY2009
Sholinganallur, Chennai	2001	Ends FY2010
Konark, Bhubaneswar	2001	Ends FY2010
Mangala, Mangalore	2001	Ends FY2010
Thiruvananthapuram	2004	

Source: Company, Kotak Institutional Equities

Exhibit 6: Exemplary cash flow generation focus

	2003	2004	2005	2006	2007	2008	2009	1QFY10
Cash generated from operating activities	206	371	344	599	862	1,149	1,409	387
Growth yoy (%)		80	(7)	74	44	33	23	
Revenues	754	1,063	1,592	2,152	3,090	4,176	4,663	1,122
Operating cash flow as % of revenues (%)	27.4	34.9	21.6	27.8	27.9	27.5	30.2	34.5

Note

(a) Cash generated includes other income.

(b) US GAAP numbers till FY2008; IFRS numbers starting FY2009.

Source: Company, Kotak Institutional Equities

Exhibit 7: Strong growth in ex-BT GBP revenues after several disappointing quarters; decline in BT revenues continues unabated

	4QFY08	1QFY09	2QFY09	3QFY09	4QFY09	1QFY10	1QFY10 change	
							qoq (%)	yoy (%)
Revenues (US\$ mn)	1,142	1,155	1,216	1,171	1,121	1,122		
Proportion of revenues from major currencies								
USD	67.0	68.4	70.4	72.5	73.4	73.4		
GBP	17.1	16.5	13.3	11.0	9.8	10.0		
Euro	6.6	7.0	7.2	6.7	7.7	7.8		
AUD	4.6	4.9	4.4	4.2	4.8	5.1		
Rest	4.7	3.2	4.7	5.6	4.3	3.7		
Revenues (US\$ mn) after translation (major currencies)								
USD invoicing	765.1	790.0	856.1	849.0	822.8	823.5	0.1	4.2
GBP invoicing	195.3	190.6	161.7	128.8	109.9	112.2	2.1	(41.1)
Euro invoicing	75.4	80.9	87.6	78.5	86.3	87.5	1.4	8.2
AUD invoicing	52.5	56.6	53.5	49.2	53.8	57.2	6.3	1.1
Average rates (versus US\$)								
GBP	1.99	1.98	1.87	1.54	1.43	1.55	8.4	(21.7)
Euro	1.53	1.56	1.49	1.32	1.29	1.36	5.4	(12.8)
AUD	0.92	0.95	0.87	0.67	0.66	0.76	15.2	(20.0)
Revenues (local currency, mn)								
USD invoicing	765.1	790.0	856.1	849.0	822.8	823.5	0.1	4.2
GBP invoicing	98.1	96.3	86.5	83.6	76.8	72.4	(5.8)	(24.8)
Euro invoicing	49.3	51.8	58.8	59.4	66.9	64.4	(3.8)	24.2
AUD invoicing	57.1	59.6	61.5	73.4	81.5	75.3	(7.6)	26.4
GBP revenues (£ mn)								
BT	59.1	46.1	49.5	47.1	44.7	35.3	(21.0)	(23.4)
Ex-BT	39.0	50.1	37.0	36.5	32.1	37.1	15.4	(26.1)

Note:

(a) Assuming 100% of BT revenues are GBP-invoiced

Source: Company, Kotak Institutional Equities

Exhibit 8: US\$ revenue productivity moved up sequentially, led by favorable cross-currency movements

Per capita revenue productivity	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09
Onsite (US\$/ year)	141,806	145,985	147,540	147,466	147,497	148,444	139,784	137,033	140,612
Offshore (US\$/ year)	58,107	59,633	60,432	60,752	60,722	60,762	57,958	55,621	55,654
Blended (US\$/ year)	85,381	87,019	87,672	87,848	88,008	87,715	82,371	79,883	80,713
Growth qoq (%)									
Onsite	1.4	2.9	1.1	(0.0)	0.0	0.6	(5.8)	(2.0)	2.6
Offshore	1.0	2.6	1.3	0.5	(0.0)	0.1	(4.6)	(4.0)	0.1
Blended	1.0	1.9	0.8	0.2	0.2	(0.3)	(6.1)	(3.0)	1.0
Growth yoy (%)									
Onsite	6.7	8.3	7.4	5.5	4.0	1.7	(5.3)	(7.1)	(4.7)
Offshore	5.3	6.9	6.5	5.6	4.5	1.9	(4.1)	(8.4)	(8.3)
Blended	5.5	6.3	5.5	4.0	3.1	0.8	(6.0)	(9.1)	(8.3)

Source: Company

Exhibit 9: Subsidiary performance - marked improvement in profitability across the board

	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09
Revenues - US\$mn									
Progeon	49.2	52.7	64.0	69.4	72.6	72.6	67.1	67.3	68.5
Infosys Australia	35.4	34.5	32.6	36.6	34.1	30.8	26.0	28.0	31.9
Infosys Consulting	12.8	16.3	16.6	15.9	17.7	17.7	13.5	13.6	14.3
Infosys China	3.8	5.1	5.0	5.3	5.8	5.8	6.7	9.1	8.2
Infosys Mexico		-	0.2	0.5	1.2	2.0	2.3	2.4	3.7
Infosys Sweden									0.2
Overall - subsidiaries	101.2	108.5	118.3	127.7	131.4	128.8	115.6	120.3	126.7
Net profits - US\$mn									
Progeon	8.1	10.3	7.3	9.1	7.3	11.0	10.9	11.5	12.3
Infosys Australia	5.7	7.4	4.6	7.7	3.4	2.1	1.6	2.9	2.7
Infosys Consulting (a)	(0.8)	(12.0)	-	(0.1)	(1.5)	(1.1)	(2.7)	(6.6)	(2.8)
Infosys China	(1.1)	(0.0)	(0.4)	(0.1)	(0.1)	(1.9)	(2.0)	1.6	0.4
Infosys Mexico		(0.1)	(0.9)	(0.8)	(0.3)	(0.8)	(0.5)	(0.1)	0.6
Infosys Sweden									-
Overall - subsidiaries	11.9	5.6	10.5	15.9	8.8	9.3	7.4	9.3	13.3
Net profit margin (%)									
Progeon	16.5	19.6	11.4	13.2	10.1	15.1	16.2	17.1	18.0
Infosys Australia	16.0	21.6	14.0	21.0	9.9	6.7	6.2	10.3	8.4
Infosys Consulting	(6.1)	(73.6)	-	(0.3)	(8.6)	(6.2)	(19.6)	(48.8)	(19.5)
Infosys China	(29.4)	(0.6)	(8.6)	(2.0)	(0.9)	(32.0)	(29.7)	17.4	5.0
Infosys Mexico			(543.9)	(167.4)	(28.9)	(42.9)	(21.3)	(2.5)	16.8
Infosys Sweden									-

Note:

(a) Consulting net income for Sep '07 quarter includes a one time US\$12 mn earn-out provision

Source: Company

Exhibit 10: Profit model, balance sheet, cash model of Infosys Technologies, 2007-2011E, March fiscal year-ends (Rs mn)

	2007	2008	2009	2010E	2011E
Profit model					
Revenues	138,930	166,920	216,930	224,584	259,090
Cost of sales	(74,580)	(92,070)	(117,650)	(121,800)	(140,741)
SG&A expenses	(20,440)	(22,470)	(27,330)	(30,206)	(35,877)
EBITDA	43,910	52,380	71,950	72,578	82,472
Depreciation	(5,140)	(5,980)	(7,610)	(9,204)	(9,928)
EBIT	38,770	46,400	64,340	63,375	72,544
Other income	3,750	7,040	4,730	9,506	11,695
Pre-tax profits	42,520	53,440	69,070	72,881	84,239
Provision for tax	(5,100)	(8,060)	(10,270)	(14,039)	(19,475)
Recurring net income	37,420	45,380	58,800	58,842	64,764
Extraordinaries	1,140	1,210	1,080	—	—
Reported net income	38,560	46,590	59,880	58,842	64,764
EPS (Rs)	67.0	79.1	102.4	102.5	112.8
Balance Sheet					
Shareholders funds	113,485	137,950	182,540	224,612	267,534
Deferred tax liability/(assets)	(920)	(1,190)	(1,260)	(1,260)	(1,260)
Borrowings	—	—	—	—	—
Minority interest	40	—	—	—	—
Total liabilities	112,605	136,760	181,280	223,352	266,274
Gross block	46,420	54,390	70,930	78,225	89,233
Accumulated depreciation	(18,360)	(19,860)	(24,160)	(33,364)	(43,292)
Net block	28,060	34,530	46,770	44,861	45,942
CWIP	9,650	13,240	6,770	6,770	6,770
Net fixed assets	37,710	47,770	53,540	51,631	52,712
Cash and bank balances	61,800	83,960	112,460	150,647	189,202
Net current assets excluding cash	13,095	5,030	15,280	21,074	24,361
Total assets	112,605	136,760	181,280	223,352	266,274
Cashflow statement					
Operating profit before working capital changes	43,800	52,380	71,950	72,578	82,472
Change in working capital/other adjustments	(10,700)	(8,590)	(3,405)	(5,794)	(3,287)
Capital expenditure	(15,100)	(14,940)	(13,270)	(7,295)	(11,008)
Investments	7,300	(470)	720	—	—
Taxes paid	(5,700)	(6,700)	(9,020)	(14,039)	(19,475)
Free cash flow	19,600	21,680	46,975	45,450	48,702

Source: Company, Kotak Institutional Equities estimates

JULY 13, 2009

UPDATE

Coverage view: **Cautious**

Price (Rs): **1,778**

Target price (Rs): **1,600**

BSE-30: **13,504**

Downside risks persist. Our review of RIL's earnings drivers and valuation components does not suggest any meaningful scope for upward revision to earnings or our SOTP-based fair valuation of Rs1,600. In fact, we see significant downside risks to our earnings and fair valuation from (1) weaker-than-expected refining and chemical margins and (2) further unfavorable developments in RIL-RNRL issue. We compute a trough-case valuation of Rs1,200 for RIL.

Company data and valuation summary

Company data and valuation summary

Reliance Industries							
Stock data			Forecasts/Valuations		2009	2010E	2011E
52-week range (Rs) (high,low)		2,535-930	EPS (Rs)		103.4	112.5	144.7
Market Cap. (Rs bn)		2,599.3	EPS growth (%)		(1.5)	8.8	28.6
Shareholding pattern (%)			P/E (X)		18.3	16.8	13.1
Promoters		42.4	Sales (Rs bn)		1,499.7	1,750.3	1,931.5
FIs		19.4	Net profits (Rs bn)		157.1	176.9	227.6
MFs		2.6	EBITDA (Rs bn)		239.8	346.7	420.0
Price performance (%)		1M	3M	12M			
Absolute		(14.4)	13.3	(9.8)	EV/EBITDA (X)		
					11.6		
Rel. to BSE-30		(6.9)	(15.0)	(13.5)	ROE (%)		
					15.1		
					14.1		
					16.2		
					Div. Yield (%)		
					0.6		
					0.7		
					0.9		

Gloomy outlook for refining and chemical margins

Our review of global refining and chemicals supply-demand balance highlights continued large imbalances for the next 2-3 years. In particular, we are very concerned about the refining business, RIL's mainstay, given an incremental surplus of around 6 mn b/d in CY2008-10E led by (1) refining capacity addition of 3.5 mn b/d and increase in OPEC NGLs supply of 1.4 mn b/d and (2) demand decline of 1 mn b/d.

Maintain SELL with a 12-month target price of Rs1,600; trough-case valuation of Rs1,200

We retain our SELL rating on RIL with a 12-month fair valuation of Rs1,600. However, we do not rule out downside risk to our fair valuation given our generous assumptions for both refining and chemical segments. We highlight that our trough-case valuation comes to Rs1,200 if we factor potential downside risks emanating from (1) weaker-than-expected refining and chemical margins and (2) further unfavorable developments in the RIL-RNRL issue.

Current assumptions leave limited scope for upward revision

We see limited scope for upward revision to our reasonably aggressive margin assumptions given the aforementioned large supply-demand imbalance in the case of both chemicals and refining. On the contrary, we do not rule out downward revisions to our chemical and refining margin assumptions and thus, to our earnings estimates. We highlight that RIL's earnings are highly sensitive to margin assumptions—a US\$1/bbl decline in refining margins impacts RIL's FY2010E consolidated EPS by 8% and a US\$50/ton decline in chemical margins impacts its FY2010E consolidated EPS by 7%.

QUICK NUMBERS

- Risk to earnings from weaker-than-expected refining and chemical margins
- Trough-case valuation of Rs1,200
- Retain SELL rating despite 21% underperformance over the past two months

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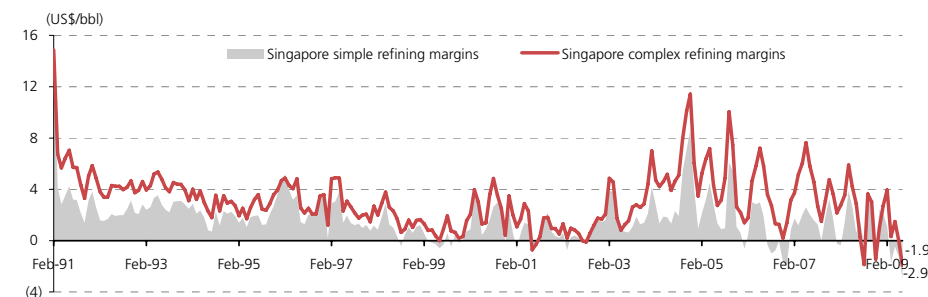
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Refining margins have collapsed and will likely remain subdued

We expect refining margins will likely remain subdued over the next 12-24 months due to (1) global demand weakness and (2) large refining capacity additions in CY2009-10E. We highlight that Singapore refining margins have plummeted to -US\$0.3/bbl in FY2010YTD from US\$2.1/bbl in FY2009 (see Exhibit 1). Also, light-heavy differential has also collapsed to US\$2.4/bbl in FY2010YTD versus US\$9.5/bbl in FY2009 (see Exhibit 2).

Refining margins have collapsed in the recent month

Singapore refining margins (US\$/bbl)



Simple refining margins, March fiscal year-ends (US\$/bbl)										
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 YTD
1Q	1.29	0.51	0.30	1.05	1.69	3.02	2.52	2.25	2.40	(1.51)
2Q	2.47	0.45	0.07	1.20	3.13	2.78	(0.70)	0.99	1.71	(2.85)
3Q	1.74	1.06	1.44	1.57	6.46	2.22	(1.25)	2.32	1.31	
4Q	0.21	(0.03)	2.98	2.88	2.08	1.09	1.25	0.25	0.65	
Average	1.43	0.50	1.20	1.67	3.34	2.28	0.45	1.45	1.52	(1.61)

Weekly margins					
Current	-1 Wk	-2 Wk	-3 Wk	-4 Wk	
(2.85)	(2.84)	(3.44)	(3.54)	(1.89)	

Singapore refining margins, March fiscal year-ends (US\$/bbl)										
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 YTD
Simple	1.43	0.50	1.20	1.67	3.34	2.28	0.45	1.45	1.52	(1.61)
Complex	1.86	1.34	0.79	1.24	4.57	4.93	3.45	4.05	2.09	(0.26)

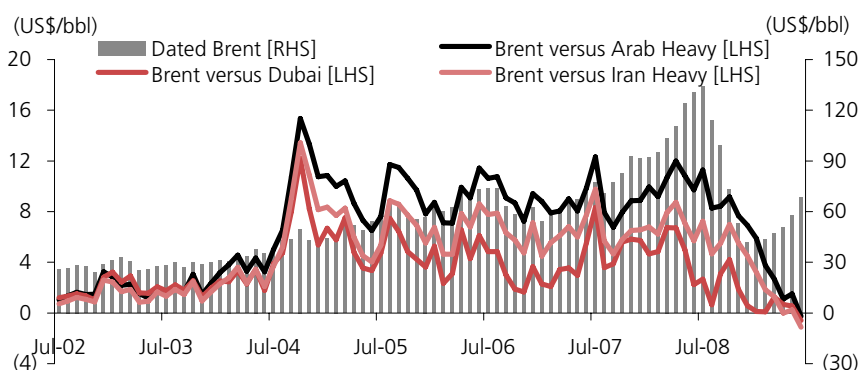
Complex refining margins, March fiscal year-ends (US\$/bbl)										
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 YTD
1Q	1.86	1.34	0.79	1.24	4.57	4.93	6.24	6.58	4.31	(0.13)
2Q	3.96	0.58	0.14	2.35	5.80	6.11	2.46	2.91	0.66	(1.88)
3Q	2.25	1.22	1.56	3.23	9.04	3.94	0.98	3.91	1.04	
4Q	1.60	0.65	3.70	5.44	5.02	2.77	4.11	2.78	2.36	
Average	2.42	0.95	1.55	3.06	6.10	4.44	3.45	4.05	2.09	(0.26)

Weekly margins					
Current	-1 Wk	-2 Wk	-3 Wk	-4 Wk	
(1.88)	(2.09)	(2.21)	(2.53)	(0.95)	

Source: Bloomberg, Kotak Institutional Equities

Light-heavy differential has contracted significantly

Light-heavy differential (US\$/bbl)



Source: Bloomberg, Kotak Institutional Equities

Demand weakness. The IEA projects global crude oil demand to remain flat in CY2008-11E. Exhibit 3 gives our supply-demand for oil. Weaker-than-expected global GDP growth may result in weaker-than-expected demand for oil. We highlight that the demand-supply balance in Exhibit 3 is based on a high-growth scenario of global GDP growth of ~4-5% over CY2011-14E. We caution that the supply-demand imbalance will be exacerbated in the case of lower global GDP growth. Exhibit 4 shows likely global oil demand and annual growth under base-case and low-growth assumptions for global GDP growth.

We expect sharp deterioration in global-supply demand balance over the next few years
Estimated global crude demand, supply and prices, Calendar year-ends, 2005-14E

	2005	2006	2007	2008	2009E	2010E	2011E	2012E	2013E	2014E
Demand (mb/d)										
Total demand	84.1	85.2	86.0	85.8	83.2	84.3	85.6	86.8	87.9	89.0
Yoy growth	1.6	1.1	0.8	(0.2)	(2.6)	1.1	1.3	1.2	1.1	1.1
Supply (mb/d)										
Non-OPEC	49.8	50.4	50.8	50.6	50.3	50.6	51.1	50.7	50.4	50.2
Yoy growth	1.0	0.6	0.4	(0.2)	(0.3)	0.3	0.5	(0.4)	(0.3)	(0.2)
OPEC										
Crude	30.4	30.5	30.5	30.5	27.7	27.7	27.9	29.2	30.4	31.5
NGLs	4.3	4.4	4.5	4.7	5.2	6.1	6.6	6.9	7.1	7.3
Total OPEC	34.7	34.9	35.0	35.2	32.9	33.7	34.5	36.1	37.5	38.8
Total supply	84.7	85.6	85.7	85.8	83.2	84.3	85.6	86.8	87.9	89.0
Total stock change	0.7	0.8								
OPEC crude capacity			34.4	34.2	34.7	35.5	35.0	34.8	35.5	35.8
Implied OPEC spare capacity			3.9	3.7	7.0	7.8	7.1	5.7	5.1	4.4
Demand growth (yoy, %)	1.9	1.3	0.9	(0.3)	(3.0)	1.3	1.5	1.4	1.3	1.2
Supply growth (yoy, %)										
Non-OPEC	2.0	1.2	0.8	(0.4)	(0.6)	0.6	1.0	(0.8)	(0.6)	(0.4)
OPEC	3.0	0.6	0.3	0.6	(6.6)	2.6	2.2	4.6	4.0	3.4
Total	1.6	1.1	0.1	0.1	(3.1)	1.4	1.5	1.4	1.3	1.2
Dated Brent (US\$/bbl)	54.4	65.8	72.7	102.0	60.0	65.0	70.0	75.0	75.0	75.0

Source: IEA, Kotak Institutional Equities

Supply-demand imbalance will be exacerbated if GDP growth is lower
World oil demand scenarios, Calendar year-ends, 2008-14E (mn b/d)

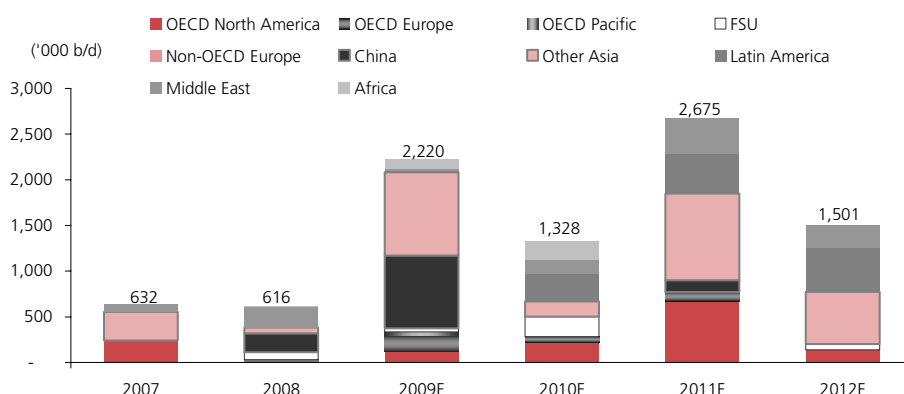
	2008	2009E	2010E	2011E	2012E	2013E	2014E
Scenario 1: high GDP growth							
Global GDP growth (%)	3.1	(1.4)	1.8	4.2	4.8	4.8	4.7
World oil demand	85.8	83.2	84.3	85.6	86.8	87.9	89.0
Scenario 2: low GDP growth							
Global GDP growth (%)	3.1	(1.4)	1.1	2.7	3.0	3.0	2.9
World oil demand	85.8	83.2	84.0	84.5	84.8	84.9	84.9

Source: IEA, Kotak Institutional Equities

Significant capacity addition. We expect refining capacity addition of 6.2 mn b/d over in CY2009-11E (see Exhibit 5). In addition, we note natural gas liquids (NGLs) supply would also increase by 1.9 mn b/d over CY2009-11E.

Significant supply additions to global refining capacity

Global refinery capacity addition, calendar year ends, 2007-2012E ('000 b/d)



Source: IEA, Kotak Institutional Equities estimates

Downside risks to our earnings estimates and fair valuation

Exhibit 6 is our SOTP valuation for RIL based on FY2011E estimates. We discuss our key assumptions and potential downside risks to the same.

SOTP valuation of Reliance is Rs1,600 per share on FY2011E estimates

Sum-of-the-parts valuation of Reliance Industries, FY2011E basis (Rs)

	Valuation base (Rs bn)		Multiple (X)		EV (Rs bn)	Value share (Rs)
	Other	EBITDA	Multiple	EV/EBITDA		
Chemicals		73		6.5	474	328
Refining & Marketing		162		6.5	1,050	728
Oil and gas—producing		27		5.0	133	92
Gas—developing (DCF-based) (a)	429	—	100%	—	429	297
Oil—KG-DWN-98/3 (b)	86	—	100%	—	86	60
Investments						
Others	27	—	100%	—	27	19
Loans & advances to affiliates less accounts payables to affiliates	83	—	100%	—	83	58
Retailing	60	—	80%	—	48	33
SEZ development	62	—	80%	—	50	34
Total enterprise value					2,381	1,649
Net debt					158	110
Implied equity value					2,223	1,540

Note:

(a) We value the KG D-6 and NEC-25 gas discoveries on DCF 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 is for 'merged' entity.

(d) We use 1.443 bn shares post merger of RPET with RIL (excluding treasury shares) for per share computations.

Source: Kotak Institutional Equities estimates

- **Refining margins.** Exhibit 7 gives our key assumptions for RIL's refinery business and RPET refinery. We assume refining margins of US\$9.4/bbl, US\$10.5/bbl and US\$11.2/bbl for FY2010E, FY2011E and FY2012E. The higher margins yoy in FY2011E reflect use of gas for internal consumption; we model flat margins in FY2011E. We highlight that RIL earnings are highly sensitive to changes in refining margins; a US\$1/bbl decline in refining margins impacts RIL's FY2010E consolidated EPS by 8%. Exhibit 8 shows the sensitivity of RIL's consolidated EPS to changes in refining margins.

Major assumptions of refinery division, March fiscal year-ends, 2004-2012E (US\$/bbl)

	2004	2005	2006	2007	2008	2009	2010E	2011E	2012E
Rupee-dollar exchange rate	46.0	45.0	44.3	45.3	40.3	45.8	48.0	47.8	47.5
RIL refinery									
Import tariff on crude (%)	10.0	10.2	5.1	5.1	1.4	1.1	0.7	0.7	0.7
Refinery yield (per bbl of crude throughput)	35.5	46.2	61.9	75.3	97.4	104.6	65.0	67.1	67.9
Cost of inputs (per bbl of crude throughput)	27.8	34.3	49.5	63.5	82.4	92.4	55.6	56.6	56.8
Landed cost of inputs	30.5	37.8	52.1						
Net refining margin	5.0	8.4	9.8	11.8	15.0	12.2	9.4	10.5	11.2
Crude throughput (mn tons)	29.6	31.5	30.5	31.8	31.8	32.0	32.0	32.0	32.0
Fuel and loss-own fuel used (%)	7.6	7.6	7.6	8.0	8.0	8.0	6.0	4.0	2.6
Fuel & loss equivalent-gas used (%)						—	2.0	4.0	5.4
Cost of natural gas used (US\$/mn BTU)						5.3	5.1	5.1	5.1
Domestic sales of gasoline and diesel (mn tons)	5.7	4.0	3.7	2.4	1.3		3.3	3.5	3.5
Exports of gasoline and diesel (mn tons)	7.6	10.2	10.0	12.3	14.1	16.6	13.3	13.7	13.7
Marketing volumes of auto fuels (mn tons)		0.8	3.3	1.9	0.8		3.3	3.5	3.5
Marketing margin of auto fuels (Rs/ton)		1,647	700	(1,190)	(1,633)		1,515	1,529	1,529
RPET refinery									
Refinery yield (US\$/bbl)						47.9	56.8	59.0	59.8
Cost of crude (US\$/bbl)						42.2	49.1	50.1	50.1
Landed cost of crude (US\$/bbl)						42.2	49.1	50.1	50.1
Net refining margin (US\$/bbl)						5.7	7.8	8.9	9.7
Crude throughput (mn tons)						3.6	26.0	29.0	29.0
Fuel and loss (mn tons)						0.3	1.6	0.8	0.8
Production of main products (mn tons)						3.3	24.4	28.2	28.2
Fuel and loss-own fuel used (%)						8.0	6.0	2.6	2.6
Fuel & loss equivalent-gas used (%)						—	2.0	5.4	5.4
Cost of natural gas (US\$/mn BTU)						5.3	5.3	5.3	5.3

Note:

(a) Refining margins do not include sales tax incentives.

Source: Kotak Institutional Equities estimates

Reliance's earnings have high leverage to refining margins

Sensitivity of RIL's consolidated earnings to key variables

	Fiscal 2010E			Fiscal 2011E			Fiscal 2012E		
	Downside	Base case	Upside	Downside	Base case	Upside	Downside	Base case	Upside
Rupee-dollar exchange rate									
Rupee-dollar exchange rate	47.0	48.0	49.0	46.8	47.8	48.8	46.5	47.5	48.5
Net profits (Rs mn)	170,906	176,944	182,982	220,515	227,611	234,708	282,074	290,081	298,087
EPS (Rs)	108.6	112.5	116.3	140.2	144.7	149.2	179.3	184.4	189.5
% upside/(downside)	(3.4)		3.4	(3.1)		3.1	(2.8)		2.8
Chemical prices									
Change in prices (%)	(5.0)		5.0	(5.0)		5.0	(5.0)		5.0
Net profits (Rs mn)	172,179	176,944	181,710	223,449	227,611	231,774	285,637	290,081	294,525
EPS (Rs)	109.4	112.5	115.5	142.0	144.7	147.3	181.5	184.4	187.2
% upside/(downside)	(2.7)		2.7	(1.8)		1.8	(1.5)		1.5
Refining margins (US\$/bbl)									
Margins (US\$/bbl)	8.4	9.4	10.4	9.5	10.5	11.5	10.2	11.2	12.2
Net profits (Rs mn)	163,067	176,944	190,816	213,098	227,611	242,122	275,667	290,081	304,493
EPS (Rs)	103.6	112.5	121.3	135.4	144.7	153.9	175.2	184.4	193.5
% upside/(downside)	(7.8)		7.8	(6.4)		6.4	(5.0)		5.0

Source: Kotak Institutional Equities estimates

- **Chemical margins.** Exhibit 9 shows our assumptions for prices and margins for RIL's key products. We highlight that we have modeled reasonably strong margins in FY20010E to reflect strong margins in April-May 2009; margins have deteriorated meaningfully since then. We expect margins to remain weak due to significant supply additions (20.8 mn tons of ethylene) in CY2009-11E. We highlight that a US\$50/ton decline in chemical margins impacts RIL's FY2010E consolidated EPS by 7%.

Key chemical prices and margins assumptions, March fiscal year-ends, 2004-12E

	2004	2005	2006	2007	2008	2009	2010E	2011E	2012E
Chemical prices									
LDPE	740	1,150	1,130	1,360	1,600	1,400	1,150	1,175	1,275
LLDPE	700	990	1,125	1,350	1,575	1,330	1,060	1,075	1,175
HDPE	700	970	1,100	1,340	1,500	1,275	1,060	1,075	1,175
Polypropylene	750	1,000	1,170	1,350	1,470	1,300	1,000	1,025	1,125
PVC	680	910	825	890	1,100	925	725	775	875
PFY	1,210	1,300	1,350	1,400	1,550	1,485	1,225	1,300	1,325
PSF	1,050	1,175	1,265	1,360	1,475	1,320	1,150	1,225	1,250
Paraxylene	585	780	900	1,225	1,200	1,085	975	1,000	900
Chemical margins									
LLDPE—naphtha	450	600	655	820	850	655	585	500	575
HDPE—naphtha	450	580	630	810	775	600	585	500	575
PP—naphtha	500	610	700	820	745	625	525	450	525
PVC—1.025 x (0.235 x ethylene + 0.864 x	258	218	264	247	396	401	259	371	471
POY—naphtha	960	910	880	870	825	810	750	725	725
PSF—naphtha	800	785	795	830	750	645	675	650	650
PX—naphtha	335	390	430	695	475	410	500	425	300
POY—0.85 x PTA—0.34 x MEG	462	334	353	329	364	496	367	425	450
PSF—0.85 x PTA—0.34 x MEG	302	209	268	289	289	331	292	350	375
PTA—0.67 x PX	208	237	222	89	121	133	97	80	147

Source: Kotak Institutional Equities estimates

- **Multiples.** We use target multiple of 6.5X FY2011E EBITDA for the chemical and refining segments, which reflects our assumptions of chemical and refining margins below mid-cycle levels. We believe a multiple of around 6X is appropriate for mid-cycle margins. We would clarify that our margins are well above trough levels.
- **Liability arising from government using government-approved gas price of US\$4.2/ mn BTU for valuation purposes.** We note that we have not factored in potential negatives of further unfavorable developments in the ongoing RIL-RNRL dispute. We assume that RIL will sell 40 mcm/d of gas to RNRL (28 mcm/d) and NTPC (12 mcm/d) at US\$2.34/mn BTU starting FY2013E for a period of 17 years. However, we do not assume additional liability to the government of India in case the government was to use US\$4.2/mn BTU to compute royalty payment, income tax liability and its share of profit petroleum. We compute a further downside risk of Rs112 in case RIL has to pay the government of India (1) royalty, (2) income tax and (3) government's share of profit petroleum at a gas price of US\$4.2/mn BTU as per the government-approved formula rather than at US\$2.34/mn BTU.

Upside potential from new gas discoveries may be some time away

We do not rule out new E&P discoveries in RIL's large portfolio of exploration blocks in India and other countries. In particular, we see potential in RIL's D3, D4 and D9 blocks. Exhibit 10 gives details of blocks in India where it has already made oil and gas discoveries and/or independent bodies have estimated possibility of large reserves.

Reliance has made new discoveries over the past few months but not yet disclosed reserves
Oil and gas discoveries of Reliance since January 2007

	Block	Area (sq. km)	Consortium	RIL's stake (%)	Comments
1	KG-DWN-98/3	7,645	Reliance, Niko	90	Oil and gas discovery in MA-2 well in February 2007
2	KG-DWN-98/3	7,645	Reliance, Niko	90	KG-D6-AA1, KG-D6-Q1 wells in deeper areas of block in February 2007
3	KG-DWN-98/3	7,645	Reliance, Niko	90	R1 well in August 2007 encountered two significant gas-bearing zones
4	NEC-OSN-97/2	14,535	Reliance, Niko	90	Dhirubhai-32 (7th) gas discovery
5	NEC-OSN-97/2	14,535	Reliance, Niko	90	Dhirubhai-40 (8th) gas discovery in Feb 2008
6	GS-OSN-2000/1	8,841	Reliance, Hardy	90	Gas discovery in May 2007
7	CY-DWN-2001/2	14,325	Reliance	100	Oil and gas discovery in July 2007
8	KG-DWN-98/1	8,100	Reliance	100	Dhirubhai-36 oil discovery in September 2007; first oil discovery in the block
9	KG-OSN-2001/2	210	Reliance	100	Gas discovery notified to DGH; commerciality to be ascertained
10	KG-OSN-2001/1	1,100	Reliance	100	Dhirubhai-38; gas discovery in January 2008
11	KG-OSN-2001/2	1,100	Reliance	100	Dhirubhai-37; gas discovery notified to DGH
12	SR-OS-94/1	6,860	Reliance	100	Oil discovery notified to DGH
13	MN-DWN-2003/1	17,050	Reliance, Niko	85	Date of drilling yet to be decided
14	KG-DWN-2003/1	3,288	Reliance, Hardy	90	Dhirubhai-39; gas discovery in February 2008
15	KG-DWN-2003/1	3,288	Reliance, Hardy	90	Second gas discovery in April 2008.
16	KG-DWN-98/3	7,645	Reliance, Niko	90	Dhirubhai-42; discovery notified to government in July 2008
17	KG-DWN-98/3	7,645	Reliance, Niko	90	Gas discovery (L-1 well) in September 2008

Note:

(a) We have included the MN-DWN-2003/1 (MN D-4) block given high expectations from this block.

Source: Company, Rigzone, Kotak Institutional Equities estimates

Our reverse valuation exercise in Exhibit 11 suggests that RIL's current stock price is factoring in US\$11 bn of value for potential E&P discoveries. This is equivalent to 20 tcf of additional gas reserves or 40 tcf of additional gas reserves to be added over the next six years (assuming a typical discovery-to-production cycle of six years).

RIL stock price is implying US\$11 bn of new discoveries of hydrocarbons in the future
Estimation of implied valuation of new businesses of Reliance Industries (US\$ bn)

		Comments
1. Valuation of extant businesses		
FY2009 EPS of Reliance (standalone) (Rs)	103	FY2009 EPS
FY2009 EPS adjusted for treasury shares (Rs)	112	Adjusted for 199 mn treasury shares and shares issued on merger of RPET
Effective tax rate in FY2009 (%)	17	
FY2009 EPS adjusted for tax rate	89	Normalized for 34% tax rate for extant earnings
Appropriate P/E multiple (X)	7	Reasonable given near peak-cycle margins, earnings in FY2009 and cost of equity of 12.5%
Valuation of extant businesses excluding RPET (Rs)	622	
Valuation of extant businesses excluding RPET	19	Reasonable in the context of replacement value, returns
FY2010E earnings of RPET (US\$ bn)	1	
FY2010E EPS of RPET (Rs)	26	
Appropriate P/E multiple (X)	9	
Valuation of RPET refinery (Rs)	233	
Valuation of extant businesses (including RPET) (Rs)	856	
Valuation of extant businesses	26	
2. Valuation of investments		
Other investments (Rs)	23	Others (without Reliance Retail)
Valuation of RIL ex-new E&P, retailing, SEZs (Rs)	878	
Current stock price	1,778	
3. Valuation of new businesses		
Market-ascribed value of new businesses	900	Emerging E&P business, retailing, SEZs
Market-ascribed value of new businesses (US\$ bn)	27	
Estimated valuation of retailing (US\$ bn)	1.0	Valued at 0.8X of amount invested (Rs60 bn) at end-FY2009E
Estimated valuation of SEZs (US\$ bn)	1.0	Value will take time to emerge
Market-ascribed value of emerging E&P business	25	Seems high based on official reserves, announced discoveries
Estimated value of Reliance's stake in KG D-6 (gas)	8.8	Based on gas production of 18.2 tcf, US\$8.8 bn capex and sale of 40 mcm/d of gas to RNRL and NTPC at US\$2.34/mn BTU
Estimated value of Reliance's stake in KG D-6 (oil)	1.8	0.5 bn bbls of OOIP assumed versus current announced reserves of 180 mn bbls
Estimated value of Reliance's stakes in NEC-25	2.3	Based on 5.1 tcf of production, US\$1.15 bn capex, US\$4.5/mn BTU
Estimated value of Reliance's stakes in CBM	1.0	Based on 2.8 tcf of production
Implied value of new discoveries	11	

Source: Kotak Institutional Equities estimates

Reliance's current stock price is implying additional recoverable reserves of ~20 tcf of gas today
Valuation of Reliance's E&P segment and implied valuation for potential discoveries (US\$ bn)

		Comments
DCF valuation of KG D-6 block, gas for D1 & D3 fields	8.8	15.4 tcf of net recoverable gas reserves
Valuation of KG D-6 block, oil for MA-1 field	1.8	450 mn bbls of net proved reserves of oil at EV/bbl of US\$10
Valuation of Reliance's stakes in NEC-25	2.3	4.6 tcf of net recoverable gas reserves
Valuation of Reliance's stakes in CBM blocks	1.0	2.8 tcf of net recoverable gas reserves
Total valuation of extant announced reserves	14	
Total recoverable reserves (tcf)	25	
Implied valuation of E&P segment	25	
Implied valuation of new E&P discoveries	11	
Implied additional recoverable reserves in stock price (tcf)	20	This is what Reliance needs to announce today
# of years from discovery to production	6	KG D-6 first gas discovered in Oct-02, production in 2H FY09
Cost of capital (%)	12	
Additional gas reserves required to be added in six years (tcf)	40	This is what Reliance needs to bring in production in six years

Note:

(a) The above exercise assumes for simplicity that all future gas and oil discovery would have similar PSC terms as the KG D-6 block.

Source: Kotak Institutional Equities estimates

Trough-case valuation of Reliance is Rs1,200 per share on FY2011E estimates

Sum-of-the-parts valuation of Reliance Industries, FY2011E basis (Rs)

	Valuation base (Rs bn)		Multiple (X)		EV (Rs bn)	Value share (Rs)
	Other	EBITDA	Multiple	EV/EBITDA		
Chemicals		55		6.5	358	248
Refining & Marketing		140		6.5	912	632
Oil and gas—producing		27		5.0	133	92
Gas—developing (DCF-based) (a)	253	—	100%	—	253	175
Oil—KG-DWN-98/3 (b)	86	—	100%	—	86	60
Investments						
Others	27	—	100%	—	27	19
Loans & advances to affiliates less accounts payables to affiliates	83	—	100%	—	83	58
Retailing	60	—	80%	—	48	33
SEZ development	62	—	80%	—	50	34
Total enterprise value					1,950	1,351
Net debt					195	135
Implied equity value					1,755	1,216

Note:

(a) We reduce chemical margins by US\$50/ton versus our base-case margins.

(b) We reduce refining margin by US\$1/bbl versus our base-case assumption.

(c) We value the KG D-6 and NEC-25 gas discoveries on DCF and CBM discoveries based on KG D-6's valuation.

(d) 180 mn bbls of recoverable reserves based on gross OOIP of 0.5 bn bbls.

(e) Net debt is for 'merged' entity.

(f) We use 1.443 bn shares post merger of RPET with RIL (excluding treasury shares) for per share computations.

Source: Kotak Institutional Equities estimates

RIL consolidated with RPL: Profit model, balance sheet, cash model, March fiscal year-ends, 2003-2012E (Rs mn)

	2003	2004	2005	2006	2007	2008	2009E	2010E	2011E	2012E
Profit model (Rs mn)										
Net sales	451,133	510,715	656,223	809,113	1,114,927	1,334,430	1,499,690	1,750,334	1,931,544	2,031,194
EBITDA	75,808	91,148	123,820	139,991	198,462	233,056	236,220	343,128	416,464	492,369
Other income	10,012	11,381	14,498	6,829	4,783	8,953	20,570	34,555	36,127	43,090
Interest	(15,552)	(14,347)	(14,687)	(8,770)	(11,889)	(10,774)	(17,450)	(51,228)	(38,166)	(17,343)
Depreciation & depletion	(28,371)	(32,470)	(37,235)	(34,009)	(48,152)	(48,471)	(51,720)	(93,053)	(102,501)	(113,944)
Pretax profits	41,897	55,711	86,397	104,041	143,205	182,764	187,620	233,403	311,923	404,172
Extraordinary items	7,845	7,300	4,290	3,000	2,000	47,335	(3,700)	—	—	—
Tax	(2,459)	(3,510)	(7,050)	(9,307)	(16,574)	(26,520)	(21,290)	(40,747)	(75,651)	(106,574)
Deferred taxation	(6,240)	(7,900)	(7,920)	(7,040)	(9,196)	(8,999)	(9,000)	(7,594)	5,186	10,677
Minority interest	—	—	—	—	—	—	(249)	(8,117)	(13,846)	(18,195)
Net profits	41,043	51,601	75,717	90,693	119,434	194,580	153,381	176,944	227,611	290,081
Adjusted net profits	34,570	45,623	72,135	88,152	117,789	152,605	156,472	176,944	227,611	290,081
Earnings per share (Rs)	25	33	52	63	81	105	103	112	145	184
Balance sheet (Rs mn)										
Total equity	303,744	344,525	404,033	430,543	673,037	847,853	1,130,178	1,274,764	1,464,478	1,702,635
Deferred taxation liability	26,848	34,748	42,668	49,708	69,820	78,725	87,725	95,320	90,134	79,457
Minority interest	—	—	—	—	33,622	33,622	33,832	38,051	47,105	57,072
Total borrowings	197,583	209,447	187,846	218,656	332,927	493,072	710,346	614,160	391,160	202,012
Current liabilities	109,666	122,855	171,315	164,545	192,305	251,427	301,513	246,007	256,570	256,749
Total liabilities and equity	637,842	711,574	805,863	863,452	1,301,712	1,704,700	2,263,594	2,268,302	2,249,446	2,297,925
Cash	1,472	2,242	36,087	21,461	18,449	42,822	256,703	246,297	232,729	307,020
Current assets	227,809	218,159	248,438	224,283	286,566	402,721	483,779	510,829	533,699	539,984
Total fixed assets	340,863	351,460	350,823	626,745	899,403	1,081,638	1,333,592	1,321,657	1,293,500	1,261,401
Investments	67,227	139,714	170,515	(9,038)	97,294	177,519	189,519	189,519	189,519	189,519
Deferred expenditure	472	—	—	—	—	—	—	—	—	—
Total assets	637,842	711,574	805,863	863,452	1,301,712	1,704,700	2,263,594	2,268,302	2,249,446	2,297,924
Free cash flow (Rs mn)										
Operating cash flow, excl. working capital	67,072	83,301	107,002	119,520	164,285	180,718	168,460	244,498	297,135	361,851
Working capital	(17,614)	20,265	46,875	(32,188)	(13,075)	(31,071)	(30,973)	(82,555)	(12,307)	(6,107)
Capital expenditure	(37,043)	(43,191)	(52,440)	(94,273)	(247,274)	(239,691)	(238,171)	(74,940)	(73,616)	(82,895)
Investments	(34,204)	(68,430)	(48,192)	(32,364)	(105,760)	(78,953)	(12,000)	—	—	—
Other income	5,219	5,902	3,032	5,159	4,143	6,132	20,570	34,555	36,127	43,090
Free cash flow	(16,569)	(2,153)	56,276	(34,146)	(197,681)	(162,865)	(92,114)	121,558	247,339	315,939
Ratios (%)										
Debt/equity	59.8	55.2	42.1	45.5	44.8	53.2	58.3	44.8	25.2	11.3
Net debt/equity	59.3	54.6	34.0	41.1	42.3	48.6	37.2	26.8	10.2	(5.9)
RoAE	10.7	12.7	17.6	19.9	20.3	18.9	15.0	14.1	16.0	17.7
RoACE	8.8	9.7	13.0	13.8	13.9	12.7	9.9	11.2	13.4	15.9

Source: Kotak Institutional Equities estimates

Deal with FRX positive for sentiment. SUNP has settled its patent litigation with FRX over Lexapro. Details of the financial arrangement are not available. The agreement needs to be approved by US government agencies. It is likely that FRX may enter into more similar agreements with other generic companies before patents expire in March 2012. The timing and size of revenues, other than upfront payments, remain difficult to forecast. We retain our estimates, price target and rating.

Company data and valuation summary

Sun Pharmaceuticals

Stock data		Forecasts/Valuations			
		2009	2010E	2011E	
52-week range (Rs) (high,low)	1,600-953	EPS (Rs)	87.8	78.5	82.5
Market Cap. (Rs bn)	231.0	EPS growth (%)	17.6	(10.6)	5.2
Shareholding pattern (%)		P/E (X)	12.7	14.2	13.5
Promoters	63.7	Sales (Rs bn)	42.7	41.7	44.5
FIs	17.1	Net profits (Rs bn)	18.2	16.3	17.1
MFs	4.1	EBITDA (Rs bn)	19.5	17.9	18.8
Price performance (%)		EV/EBITDA (X)	10.0	10.1	8.9
Absolute	(15.6)	ROE (%)	31.6	22.6	19.9
Rel. to BSE-30	(3.8)	Div. Yield (%)	1.2	1.2	1.2
1M	3M	12M			
	(15.6)	(2.9)	(15.3)		
	(3.8)	(21.2)	(15.5)		

Lexapro is an important product for Forest Labs

Lexapro (escitalopram oxalate tablets) is used in the treatment of depression and is covered by US composition of matter patent which expires in March 2012 inclusive of a pediatric extension. Forest Labs (FRX) has licensed this product from Lundbeck. FRX launched Lexapro in 2002 and its revenues in FY2009 were \$2.3 bn. This was 63% of FRX sales for the year.

In September 2007, Forest received a favorable judgment that has prevented Teva from launching generic version of Lexapro. CPD filed its patent challenge in July 2006 and agreed that it infringed on FRX patents but continued to argue that FRX patents were invalid. There are several other generic companies who have filed similar patent challenges to Lexapro.

SUNP reaches settlement with FRX

SUNP and CPD announced that they had entered into agreements with FRX to settle the legal proceedings related to Lexapro. The agreement contains the following provisions:

- ▶ SUNP will license to Lundbeck, on a worldwide basis, certain patent applications related to the synthesis of escitalopram and citalopram in exchange for an upfront payment and, if the technology is used, royalties on sales.
- ▶ FRX will provide licenses to CPD for any patents related to Lexapro and with respect to the marketing of Caraco's generic version of the product as of the date that any third party generic that has received final approval from the FDA enters the market other than an authorized generic or the first filer with Hatch-Waxman related exclusivity. Thus, SUNP is allowed to launch its version of Lexapro as soon as any other generic company receives approval from US FDA.
- ▶ CPD will take over the commercialization and sale of several products from FRX Inwood business. Caraco will pay FRX an undisclosed advance against royalties and royalties on net sales of these products. The range of products that Inwood has put out on its website is given below. CPD has not clarified which products are to be sold through CPD network. This would be a good additional revenue source for CPD as FRX will continue to be responsible for manufacturing. FRX will reimburse CPD for a portion of their costs related to this litigation.

ADD
JULY 13, 2009
UPDATE

Coverage view: **Attractive**

Price (Rs): **1,115**

Target price (Rs): **1,665**

BSE-30: **13,504**

- Lexapro generated US\$2.3bn revenues in FY2009
- 40 days provided for US government review
- No clarity on size and time of upside to SUNP

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List of products sold by Inwood Labs

Category	Brand	Generic
Depression	Celexa	Citalopram HBr
Angina	Tiazac	Diltiazem HCl
Angina	Isochron	Isosorbide Dinitrate
Hypertension	Tiazac	Diltiazem HCl
Asthma	Theochron	Theophylline Tablets
Asthma	TheoCap	Theophylline Capsules
Cough Suppression	Tessalon	Benzonatate

This needs to be approved by US FTC and DOJ

These agreements will be subject to review by the U.S. Federal Trade Commission. The terms of the settlement will be submitted to the Federal Trade Commission and the Department of Justice pursuant to the Medicare Modernization Act. The agreement is scheduled to close no sooner than 40 days after the signing, which may provide the FTC and DOJ with sufficient time to review the transaction.

Difficult to quantify size and timing of upside

We are not in a position to quantify the financial implication of this transaction as both parties have not shared any details. As the transaction must be submitted to the FTC and DOJ, there is a possibility that the transaction may need to either be revised, or it may not be consummated, and the litigation would be re-instituted. Further, FRX is involved in litigation relating to Lexapro patents with several other companies so more such agreements may get announced over the next few years before patents expire. Thus, the upfront payment that SUNP may report in quarter ending September is the only revenue for SUNP in the short term. SUNP, through its subsidiary CPD, will also start booking revenues from Inwood Labs on approval by the US government agencies.

Despite these challenges, we think this is a positive development for SUNP's share price. It shows that the management is trying to find additional revenue streams for CPD as it continues to face ban on its products manufactured in Detroit. We are not making any changes to estimates for FY2010 though upfront payment from Lundbeck is likely to be received if the deal is approved by US government agencies.

Through its subsidiary CPD, SUNP will also start booking revenues from Inwood Labs on approval by the US government agencies

JULY 13, 2009

UPDATE

BSE-30: 13,504

June 2009 numbers cheerful. All segments continue to show growth with 2-wheelers growing 17% yoy and domestic passenger cars growing 8% yoy. LCVs outperformed with a 10% yoy growth while M&HCVs declined 31% yoy. Sequentially however, M&HCVs saw a 29% increase, mirroring IIP trends.

2W and 3W: 2-wheeler growth better than May--sales up 17% yoy; Hero Honda gets the spoils

2-wheeler sales continued at the new levels set in 4QFY09 and growth could continue at these levels through August, unless the monsoon plays spoil-sport. Scooters outpaced motorcycle growth for the second month in a row. Hero Honda outperformed by a wide margin as sales grew 23% yoy while Bajaj and TVS showed smaller declines. Hero Honda's market share grew 340 bps yoy. Industry 3W sales increased 13% yoy, primarily driven by strong demand for passenger carriers. Bajaj continued to consolidate its position with a 50 bps improvement in domestic 3W market share in June.

Cars and UVs: Domestic passenger car sales grew 8% yoy

Car industry car sales grew 8% yoy led mainly by strong growth in the compact car segment. Demand from rural areas, increase in disposable income (led by Pay Commission pay-outs) and discounts led to a large spurt in compact cars. Maruti's market share grew 100 bps to 52.2% versus 51.2% a year ago but was down 440bps from May. The compact segment grew 23% domestically. Maruti's share of the compact segment declined by 500 bps from May. This was primarily driven by the weekly maintenance shutdown at Maruti's plants and new product introductions from Honda Jazz and Fiat Grand Punto. We would not read too much into this data point. Industry UV sales increased 10% yoy in June with Mahindra seeing a 65% yoy increase.

CVs and tractors: CV volumes saw good growth sequentially mirroring IIP trends

Industry CV sales declined 12.5% yoy in June. LCVs outperformed with a 10% yoy growth while M&HCVs declined 31% yoy. Sequentially however, M&HCVs saw a 29% increase. The sequential increase could be traced to the improvements we are seeing on industrial production. IIP growth of 2.7% recorded another improvement from April. However, the lower absolute levels of growth could keep 1HFY10 volumes down. Tata Motors continued to gain market share on the back of strong LCV sales.

Stocks: Sales showing stability, but expectations might be running ahead of itself

We continue to see the industry leaders performing strongly in their respective segments as they seem to be capturing most of the incremental demand. At the industry level, sales seem to be stabilizing at current levels for most segments. However, stock valuations seem to be discounting significant growth from here, which could prove to be presumptuous. We are seeing competition heating up in the hatchback segment with Fiat entering the market with a price-competitive product and Hyundai launching a diesel i20. On the 2-wheeler side, Bajaj announced its entry into the 100cc segment and is expected to be followed closely by Honda. In a recent report, we showed how increasing industry volumes make investment plans of competitors more viable, which results in existing players losing their cost advantage.

QUICK NUMBERS

- Hero Honda's market share grew 340 bps yoy
- Industry UV sales increased 10% yoy in June with Mahindra seeing a 65% yoy increase

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JULY 13, 2009

UPDATE

BSE-30: 13,504

IIP starts the climb up the hill with 2.7% growth in May. IIP growth in May 2009 touched 2.7%—the highest after the world changed with the collapse of Lehman in September 2008. In our view, the cyclical upturn has begun with IIP growth likely to cross 4% in June and average 9% in 2HFY10E. However, the adverse impact of a larger fiscal deficit and deficient monsoon could be a drag on recovery.

Intermediate and consumer durables lead the recovery

IIP growth touched 2.7% in May—the highest in eight months. The better growth was led by intermediate goods and consumer durables which grew 6.1% and 12.4% yoy, respectively.

IIP growth cycle has bottomed out; we expect significant growth acceleration in 2HFY10

In our view, the IIP growth cycle has turned with growth returning in April 2009. We see IIP growth crossing 4% in June. In the absence of new exogenous shocks, IIP growth could average about 3.5% in 1HFY10E and 8.5% in 2HFY10E with overall growth exceeding 6% in FY2010E

High fiscal deficit and deficient monsoon may slow down recovery

Three factors which can come in way of the industrial growth bouncing back in FY2010E are (1) high fiscal deficit which could raise interest rates and dampen investment demand, (2) deficient monsoon which can create input supply bottlenecks and raise raw material prices besides dampening rural demand and (3) global oil prices rising past US\$75/b.

Core industries bottlenecks require closer look

In our view, the industrial production levels of some of the core industries, especially crude oil and refined petro-products are stagnating and require a closer look to put remedial measures in place. Refinery products growth has fallen on account of slack demand and margin pressures. Crude oil supplies have been impacted due to plant maintenance issues. Better monitoring of these sectors, with a view to iron out any constraints, can help improve overall growth

QUICK NUMBERS

- IIP growth at 8-month high of 2.7% in May 2009
- IIP growth may exceed 4% in June; exceed 6% in FY2010E

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May IIP a positive surprise; sets recovery in place

May IIP growth of 2.7% was largely in line with our expectations and above the street consensus of 1.4% (market estimates range -1.8% to +3.8%). The major highlights of the May IIP growth (see Exhibit 1) were:

- It was the highest growth since the collapse of Lehmann in September that precipitated strains in global credit markets and led to recession in many advanced countries.
- The upturn was led by manufacturing activity, which increased 4.6% mom from the seasonal dip typical in April that follows the March end-FY bulge.

Exhibit 1: Positive surprise in May IIP growth led by improved manufacturing activity

Sectoral classification of IIP growth, March fiscal year-ends, 2008-2010 (%)

	Mining (%)			Manufacturing (%)			Electricity (%)			General (%)		
	2008	2009	2010	2008	2009	2010	2008	2009	2010	2008	2009	2010
Weights (%)	10.5			79.4			10.2			100.0		
April	2.6	6.1	3.9	12.4	6.7	0.4	8.7	1.4	7.1	11.3	6.2	1.2
May	3.8	5.5	3.7	11.3	4.5	2.5	9.4	2.0	3.3	10.6	4.4	2.7
June	1.5	0.1		9.7	6.1		6.8	2.6		8.9	5.4	
July	3.2	2.8		8.8	6.9		7.5	4.5		8.3	6.4	
August	14.7	2.8		10.7	1.7		9.2	0.8		10.9	1.7	
September	4.9	5.8		7.4	6.2		4.5	4.4		7.0	6.0	
October	5.1	3.2		13.8	(0.6)		4.2	4.4		12.2	0.1	
November	6.3	0.7		4.7	2.7		5.8	2.6		4.9	2.5	
December	5.0	2.2		8.6	(0.6)		3.8	1.6		8.0	(0.2)	
January	2.9	0.7		6.7	1.0		3.7	1.8		6.2	1.0	
February	7.9	(0.2)		9.6	0.2		9.8	0.7		9.5	0.2	
March	4.9	2.6		5.7	(1.6)		3.7	6.3		5.5	(0.8)	
YTD (April-May)	3.2	5.8	3.8	11.8	5.6	1.5	9.0	1.7	5.1	10.9	5.3	1.9

Source: Central Statistical Organization

- In terms of use-based sectors, the revival was led by intermediate goods that expanded 6.1% yoy and consumer durables that jumped 12.4% yoy. Consumer durables have recorded a good growth for the fourth month in succession (see Exhibit 2).
- Capital goods and consumer non-durables contracted 3.6% yoy and 2.3% yoy, respectively. Capital goods production has now registered negative growth for the third consecutive month and consumer non-durables for the fourth month.

Exhibit 2: May 2009 IIP growth improvement led by intermediate good and consumer durables

Use-based classification of IIP growth, March fiscal year-ends, 2008-2010 (%)

	Basic goods			Capital goods			Intermediate goods			Consumer goods			Consumer durables			Consumer non-durables		
	2008	2009	2010	2008	2009	2010	2008	2009	2010	2008	2009	2010	2008	2009	2010	2008	2009	2010
Weights (%)	35.6			9.3			26.5			28.7			5.4			23.3		
April	8.6	4.0	4.7	10.9	12.4	(7.3)	10.6	3.1	7.3	14.7	8.5	(3.6)	2.4	3.2	17.2	18.7	10.0	(9.1)
May	10.3	3.0	3.8	22.4	4.3	(3.6)	8.8	1.9	6.1	8.7	7.4	1.2	(0.7)	2.8	12.4	12.1	9.0	(2.3)
June	9.2	2.2		23.1	7.8		8.6	2.8		3.6	9.9		(3.6)	4.6		6.3	11.6	
July	8.7	5.3		12.3	17.9		7.7	3.0		7.1	5.9		(2.7)	13.9		10.5	3.4	
August	12.7	3.9		30.8	0.9		13.8	(5.5)		(0.0)	6.4		(6.2)	3.9		2.4	7.3	
September	6.5	5.0		20.9	20.8		10.1	(2.5)		(0.2)	7.4		(7.3)	14.7		2.6	4.8	
October	6.5	3.2		20.9	(24.3)		13.9	(4.4)		13.7	(0.9)		9.0	(1.6)		15.8	(0.6)	
November	5.2	2.2		24.2	0.5		5.5	(3.9)		(2.9)	9.4		(5.5)	0.3		(2.0)	12.4	
December	3.4	2.0		17.6	6.6		7.6	(8.9)		8.7	1.7		2.8	(4.2)		10.3	3.2	
January	3.6	(0.7)		2.6	15.9		8.0	(7.2)		8.4	3.6		(0.5)	2.1		11.1	4.0	
February	7.3	(0.1)		10.7	11.8		8.5	(3.0)		11.7	(1.3)		3.1	6.0		14.3	(3.4)	
March	3.3	2.1		20.3	(8.4)		4.9	0.9		0.9	(0.6)		(2.0)	8.2		1.9	(3.3)	
YTD (April-May)	9.5	3.5	4.2	16.9	8.0	(5.4)	9.7	2.5	6.7	11.6	8.0	(1.2)	0.8	3.0	14.7	15.4	9.5	(5.8)

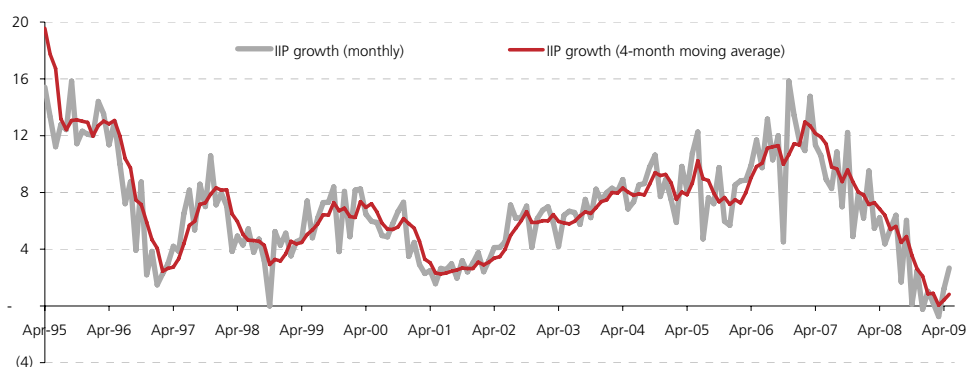
Source: Central Statistical Organization

IIP growth cycle has bottomed out

In our assessment, the IIP growth cycle bottomed out in March 2009. The downturn had begun from April 2007. On a 4-month Moving Average basis the growth IIP dropped to 0.1% in March 2009 from 13.0% in February 2007 (see Exhibit 3).

Exhibit 3: IIP growth has bottomed out after two-years of cyclical slowdown

IIP growth on a monthly and 4-month moving average basis, March fiscal year-ends, 1996-2010 (%)



Source: Central Statistical Organization, Kotak Institutional Equities

IIP growth likely to exceed 4% in June 2009

We expect the two-year cyclical slowdown to reverse and lead to significant expansion in FY2010. Our projections suggest:

- ▶ IIP growth likely to exceed 4% in June 2009
- ▶ IIP growth likely to average over 3.5% in 1HFY10E (revised from our earlier estimate of 2.5%)
- ▶ We expect a significant acceleration in 2HFY10 with IIP growth averaging 8.5%
- ▶ IIP growth is likely to exceed 6% in FY2010E

The expansionary phase has already begun and may accelerate ahead on favorable base effects, sustained consumption demand and likely inventory additions after firms having depleted inventories quickly in 2HFY09. If investment demand picks up significantly in 2HFY10, there could be further upside to our IIP growth estimates.

Risks to recovery from rising fiscal deficit and deficient monsoon

Our projected recovery path could be at risk from several factors that could slow down but not arrest the process.

- ▶ **Large fiscal deficit raising the central government's net borrowing** to Rs4.0 tn in FY2010E from Rs2.6 tn in FY2009 and Rs1.3 tn in FY2007. This 3X increase in government borrowing can put pressures on interest rates, especially from 4QFY10 when monetary policy cycle may turn to a tightening phase
- ▶ **Monsoon deficient with rainfall till July 8 36% short of the norm.** If this deficiency remains and a drought occurs, it could impact industrial growth from both demand and supply side. Rural demand, which has been a significant driver of growth in recent period could suffer. Also, the availability and cost of raw material supply could impact industrial production levels

- **Soft oil prices would aid recovery.** However, a surge in oil prices to beyond US\$75/b can change macro-economics and act as an additional drag on growth. Oil at an average of US\$70/b can raise oil bond issuances to Rs280 bn (Rs480 bn if it averages US\$80 per barrel) and can put additional pressure on interest rates. Alternatively, if higher oil prices are passed on domestically, it can impact input costs and impact recovery. Higher oil prices can also impact trade deficit and require import compression at the cost of growth.

Need to turn around some core industries

Of the six core industries which have a 26.7% weight in IIP, coal and cement production has been buoyant (see Exhibit 4). However, the performance of crude oil, refinery products and also to some extent electricity and steel require closer monitoring and policy support to realize good IIP growth.

Exhibit 4: Mixed performance of six core infrastructure industries

Sector-wise growth rates in production for six infrastructure industries, March fiscal year-ends, 2009-2010 (%)

	Crude Oil		Refinery		Coal		Electricity		Cement		Finished Steel		General	
	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010
Weights (%)	4.2		2.0		3.2		10.2		2.0		5.1		26.7	
April	1.0	(3.1)	4.3	(4.5)	10.3	13.2	1.4	7.1	6.9	11.7	(0.6)	2.8	2.3	5.0
May	3.2	(4.3)	0.1	(4.3)	8.8	10.2	2.0	3.3	3.8	11.6	3.3	1.4	3.1	2.8
June	(4.7)		5.6		6.2		2.6		6.6		5.6		3.8	
July	(3.0)		11.8		5.5		4.5		8.9		6.0		6.4	
August	(1.0)		2.5		5.9		0.8		1.9		3.4		(0.1)	
September	(0.4)		2.8		10.7		4.4		8.1		2.1		5.7	
October	(0.3)		5.0		10.9		4.4		6.2		(4.9)		(1.2)	
November	0.5		(1.1)		9.6		2.6		8.7		(2.5)		1.5	
December	(0.3)		3.0		9.4		1.5		11.6		(6.0)		1.1	
January	(8.1)		(1.3)		6.3		1.8		8.3		1.6		1.8	
February	(6.2)		0.5		6.0		0.6		8.3		0.5		1.4	
March	(2.3)		3.3		5.2		6.3		10.1		(2.2)		3.2	
YTD (April-May)	2.1	(3.7)	2.1	(4.4)	9.5	11.7	1.7	5.1	5.4	11.7	1.4	2.1	2.7	3.9

Source: Ministry of Industries

Source: Company, Bloomberg, Kotak Institutional Equities estimates

Note:
(1) For
(2) 20
(3) EV
(4) RL

Note:

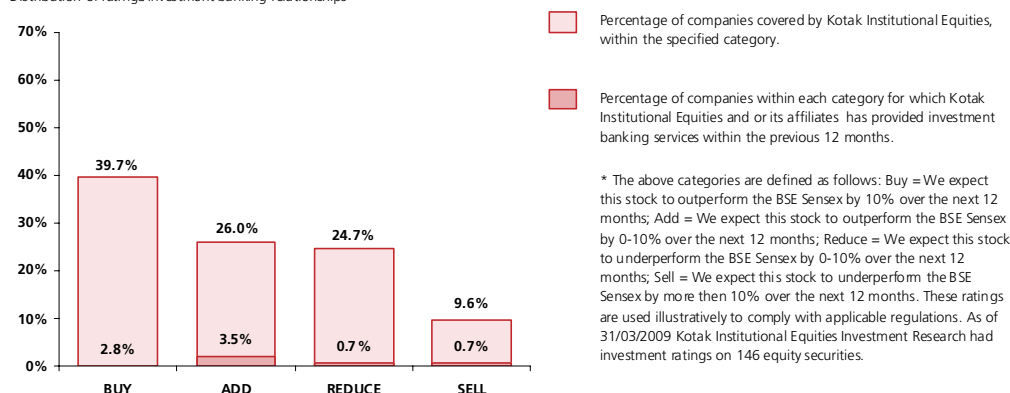
- (1) For banks we have used adjusted book values.
- (2) 2009 means calendar year 2008, similarly for 2010 and 2011 for these particular companies.
- (3) EV/Sales & EV/EBITDA for KS universe excludes Banking Sector.
- (4) Rupee-US Dollar exchange rate (Rs/US\$)= 48.95

Source: Company, Bloomberg, Kotak Institutional Equities estimates

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As of March 31, 2009

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