kotak Institutional Equities

INDIA DAILY

April 20, 2007

EQUITY MARKETS

		Change, %		
India	**19-Apr**	**1-day**	**1-mo**	**3-mo**
Sensex	13,620	(0.4)	7.2	(4.0)
Nifty	3,998	(0.3)	8.1	(2.3)
Global/Regional indices				
Dow Jones	12,809	0.0	4.2	1.9
Nasdaq Composite	2,505	(0.2)	4.0	2.2
FTSE	6,441	(0.1)	3.5	3.3
Nikkie	17,460	0.5	1.7	0.9
Hang Seng	20,497	1.0	5.9	0.8
KOSPI	1,530	1.1	6.0	12.5

Value traded - India

		Moving avg, Rs bn		
	19-Apr		**1-mo**	**3-mo**
Cash (NSE+BSE)	122.3		112.4	124.8
Derivatives (NSE)	335.5		243.4	376.0
Deri. open interest	581.1		578.2	627.3

Forex/money market

		Change, basis points		
	19-Apr	**1-day**	**1-mo**	**3-mo**
Rs/US$	42.1	-	(167)	(209)
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	8.1	(2)	2	25

Net investment (US$mn)

	18-Apr		MTD	CYTD
FIIs	145		819	40
MFs	(60)		(11)	(303)

Top movers -3mo basis

		Change, %		
Best performers	**19-Apr**	**1-day**	**1-mo**	**3-mo**
BEL	1,733	2.4	14.7	33.7
SAIL	126	0.2	21.9	29.9
Punjab Tractors	300	0.1	(2.5)	25.6
Balaji Telefilms	161	(2.7)	38.1	21.0
Bharti Tele	818	0.6	10.7	19.9
Worst performers				
Acc	788	(3.5)	5.3	(28.7)
Tvs Motor	57	(2.3)	(9.2)	(28.6)
Century Tex	559	(1.0)	6.7	(25.3)
Tata Motors	713	(1.2)	(7.3)	(24.9)
Ingersoll Rand	288	2.2	0.3	(24.0)

Contents

News Roundup

Corporate

- Japan's Nissan Motor today admitted that it was eyeing India's burgeoning small and compact car market. The company on Thursday introduced its luxury sedan Teana priced at Rs 20.47 lakh (ex-showroom Delhi). (BS)
- French dairy foods company Group Danone has decided to return the Tiger brand to Britannia Industries, its equal joint venture with the Wadias. (BS)
- Star TV India will set up a joint venture with Balaji Telefilms to take on the regional channels . The venture will launch regional language entertainment channels. The joint venture, 51 per cent of which will be owned by Star and 49 per cent by Balaji, will be headquartered in Chennai and will look at launching general entertainment channels in Telugu, Kannada and Malayalam in two to three years.(BS)
- Foreign Direct Investments (FDI) of $500 million will come into the country with the Cabinet Committee on Economic Affairs (CCEA) clearing a proposal of the GVK Power and Infrastructure Ltd (GVKPIL) to issue over 7.8 mn shares to non resident Indians shareholders of its sister concern GVK Industries Ltd (GVKIL). (BS
- Zydus Cadila is strengthening its base in Japan, the world's second largest pharma market. The company on Thursday acquired 100 per cent stake in Nippon Universal Pharmaceutical, a privately held company headquartered in Tokyo (BS)

Economic and political

- India Meteorological Department (IMD) has forecast a 'near normal' (or slightly below average) monsoon for the country during the June to September season this year. The monsoon this year is likely to be 95 per cent of the long-period average, with a model error of plus or minus 5 per cent.(BL)
- The government on Thursday decided to exempt services exports from service tax and expanded the scope of a host of schemes to boost merchandise exports while fixing a target of $160 billion for 2007-08 (BS)
- Union Finance Minister P Chidambaram has asked public sector banks to go slow on disbursals of home and other consumption loans to help fight inflation. (BS)

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

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Cement

ACC.BO, Rs788	
Rating	L
Sector coverage view	Neutral
Target Price (Rs)	810
52W High -Low (Rs)	1192 - 625
Market Cap (Rs bn)	147.6

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	56.5	64.3	68.4
Net Profit (Rs bn)	10.5	12.4	12.4
EPS (Rs)	56.3	66.4	66.5
EPS gth	*78.6*	*18.0*	*0.1*
P/E (x)	14.0	11.9	11.9
EV/EBITDA (x)	8.4	7.4	7.0
Div yield (%)	2.1	2.2	2.2

Shareholding, December 2006

	Pattern	% of Portfolio	Over/(under) weight
Promoters	35.2	-	-
FIIs	24.4	0.8	0.1
MFs	5.2	1.0	0.3
UTI	-	-	(0.7)
LIC	9.9	1.8	1.1

ACC: 1QCY07 performance inline with expectations; retain In Line rating

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- **Strong profit growth despite volumes decline.**
- **Targeting installed capacity of 27.5 mn tpa by end-CY2009.**
- **Unexciting growth prospects in the absence of loss of pricing power - retain IL.**

ACC reported 26% yoy increase in net revenues at Rs16.74 bn (our estimate of Rs16.73 bn), 61% increase in EBITDA at Rs5.07 bn (our estimate of Rs5.05 bn) and 40% increase in net profits at Rs3.44 bn (our estimate of Rs3.32 bn) for 1QCY07. Reported profits for the quarter at Rs3.64 bn include extraordinary gains of Rs0.2 bn from divestment of stake in two companies'Everest Industries and Almatis ACC. Sales volumes declined by 2.4% yoy as some of the plants operated at lower capacities to enable maintenance and capacity augmentation. Improvement in realizations (29% yoy) resulted in the strong financial performance. We believe that earnings growth for ACC will largely be driven by volumes growth and cost savings and have not factored any price increases in our estimates. Our EPS estimates remain unchanged at Rs66.4 for CY2007 and Rs66.5 for CY2008 respectively. We retain our In Line rating on the stock and target price of Rs810/share.

Strong profit growth despite volumes decline. Higher cement prices resulted in ACC reporting a strong growth in EBITDA at 61% yoy despite a marginal volumes decline of 2.4%. Higher operating costs as compared to December quarter were compensated by price increases taken during the quarter. ACC increased cement prices during the quarter to recover the higher excise duty incidence as a result of the dual duty structure introduced in the Union Budget.

Targeting installed capacity of 27.5 mn tpa by end-CY2009. ACC is working on several projects spread across its manufacturing facilities to increase the production capacity to 27.5 mn tpa by end-CY2009 from the current 21 mn tpa. The expansion project at Lakheri plant (capacity increase of 0.6 mn tpa and 25 MW captive power plant) was completed during the quarter and the trial production has started. ACC is augmenting grinding capacities at Tikaria, Kymore, Wadi and Sindri in 2007 to increase the total cement capacity to 23.1 mn tpa. Capacity expansion at Madukkarai by 0.22 mn tpa and Bargarh Cement (by 1.2 mn tpa) will likely get completed in 2008. ACC also plans to increase the capacity at Wadi by 3 mn tpa by end-2009.

Unexciting growth prospects in the absence of loss of pricing power. We expect the earnings growth during CY2007 and CY2008 to be muted in the absence of further price increases and moderate volumes growth (8-9%). Cement manufacturers, under pressure from the Government, have committed to keep the retail cement prices stable for the next 12 months. Thus the cement manufacturers have lost the pricing power one-year earlier than the expected peak of the cycle. We expect capacity addition during FY2009 to be ahead of incremental cement demand.

Retain In Line rating with target price of Rs810/share. ACC is trading at 7.4X EV/EBITDA on FY2008E, closer to the lower band of its historic trading range of 6-14X. However, on an asset valuation basis, ACC is trading at EV/ton of US$147/tonne—much above the replacement cost of $85-90/tonne. We retain our In Line rating on the stock.

Quarterly results for ACC Limited, December yearends (Rs mn)

			yoy
	Mar 2007	Mar 2006	% chg
Sales	**16,748**	**13,275**	***26***
Operating costs			
Raw materials	(2,230)	(2,324)	*(4)*
Employee costs	(816)	(876)	*(7)*
Freight costs	(2,587)	(2,011)	*29*
Power costs	(2,658)	(2,295)	*16*
Purchased cement	(128)	(103)	*24*
Other expenditure	(3,259)	(2,516)	*30*
Total operating costs	(11,677)	(10,125)	*15*
EBITDA	**5,071**	**3,151**	***61***
EBITDA margin (%)	30.3	23.7	
Other income	284	446	*(36)*
Interest	(40)	(194)	*(79)*
Depreciation	(621)	(594)	*5*
PBT	**4,694**	**2,809**	***67***
Current tax (expense)/income	(1,256)	(357)	
Deferred tax (liability)/asset	-	-	
Net income	**3,438**	**2,452**	***40***
Extraordinaries	**200**	**(98)**	
Reported net income	**3,638**	**2,355**	
Sales, mn tonnes	**4.9**	**5.1**	***(2.4)***
Realization (Rs/tonne)	**3,396**	**2,628**	***29***
Operating costs (Rs/tonne)			
Raw materials	452	460	*(2)*
Employee costs	165	173	*(5)*
Freight costs	524	398	*32*
Power & fuel costs	539	454	*19*
Purchased cement	26	20	*27*
Other expenditure	661	498	*33*
Profitability (Rs/tonne)	**1,028**	**624**	***65***

Source: Company data, Kotak Institutional Equities estimates

Calculation of target prices using our multi-stage valuation process

	ACC
Dec 2007 CROGCI/WACC (X)	2.08
Assigned premium of EV/GCI to CROGCI/WACC (%)	17
Assigned EV/GCI (X)	2.43
GCI (Rs bn)	60.9
EV (Rs bn)	147.9
Net debt (Rs bn)	(4.4)
Market cap (Rs bn)	152
No. of shares (fully diluted)	187
Implied price (Rs)	814
Target price (Rs)	**810**

Source: Kotak Institutional Equities estimates

Pharmaceuticals

BION.BO, Rs509	
Rating	IL
Sector coverage view	Neutral
Target Price (Rs)	460
52W High -Low (Rs)	532 - 306
Market Cap (Rs bn)	50.9

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	9.9	11.7	13.6
Net Profit (Rs bn)	2.0	2.3	2.6
EPS (Rs)	20.0	22.7	25.7
EPS gth	*15.0*	*13.6*	*12.9*
P/E (x)	25.5	22.4	19.8
EV/EBITDA (x)	17.8	14.7	12.8
Div yield (%)	0.6	0.8	1.0

Shareholding, December 2006

	Pattern	% of Portfolio	Over/(under) weight
Promoters	60.9	-	-
FIIs	10.7	0.1	(0.1)
MFs	1.7	0.1	(0.1)
UTI	-	-	(0.1)
LIC	-	-	(0.1)

Biocon: Strong performance

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- **FY2007 net profit is up 15% to Rs2 bn, ahead of our estimates**
- **Raising EPS by 8% to Rs22.7 in FY2008 and Rs25.7 in FY2009**
- **Strong capex cycle raises the possibility of an equity issuance in our opinion**
- **Maintain IL rating with revised target price of Rs460, 18X FY2009 earnings.**

Q4FY2007 net profit is up 28% to Rs603 mn versus our estimate of Rs453 mn. For the full year, net profit is up 15% to Rs2 bn, on the back of 25% growth in revenues. License fees (mainly from insulin) was Rs260 mn, or 12% of PBT. The management has said that such fees are likely to recur, though quarterly blips are possible. We have raised FY2008 and FY2009 earnings by 8%, mainly on the back of higher licensing fees. We have modeled Rs430 mn for FY2008 and FY2009, arising from insulin and other products. For FY2008, we expect 19% growth in revenues and 14% growth in EPS to Rs22.7. For FY2009; we have modeled 16% growth in revenues and 13% growth in net profit. While operating margin is likely to remain at 29% level, sharp rise in depreciation is impacting earnings growth. Asset-turnover ratio of the company has almost halved to 0.9X in FY2007. Yet another round of fresh capex (Rs7.5-10 bn) over the next three years raises the possibility of an equity issuance in our opinion. While it is possible to fund this capex through internal accruals and debt, we believe the company might be more comfortable with the equity route. Long-term, we believe company is making the right moves on contract research, bio-similars and innovative biotech medicines. We have raised our DCF-based price target to Rs460 (rolled over to FY2009), or 18x FY2009 earnings. The market seems to be factoring in optimism on oral insulin product; a potential outlicensing deal (though unlikely in the near term). We have an Inline rating on the stock.

Revenue growth quarter was 30% for Q4 and 25% for FY2007. Research services grew by 48% (14% of sales) and bio-pharma segment (74% of sales) grew by 30% in Q4. Key drivers in the bio-pharma portfolio are insulin, immunosuppressants and domestic formulations division. Statins too grew in the quarter, and the company has about 22% market share in simvastatin and 21% in pravastatin in the US market. We believe that reducing contribution from statins (~37% of total sales, down from 60% two years back) denotes a healthy trend, as other categories, like immunosuppressants and anti-diabetics are picking up. For FY2007, revenue growth was 25%, on the back of 21% growth in bio-pharma and 36% growth in research services.

We expect research services to grow by 37% in FY2008 and 46% in FY2009. The bio-pharma business will likely grow by 15% in FY2008 and 11% in FY2009. Overall, our model assumes revenue growth of 19% in FY2008 and 16% in FY2009.

Margins only marginally down; benefiting form license fees, forex gains and increased in-house manufacturing. EBITDA margin for the year was 28.7% versus 29% in the previous year. Strangely there was a sharp dip in operating margins of Syngene. For the next two years, we expect operating margin to remain at 29% levels. While rise in research cost and lower realizations in statins are likely to be a pressure point, there would be benefit from license fees and increased volumes in other bio-pharma products. Depreciation has risen sharply, with the commissioning of the new plant. However this has yielded the benefit of lower manufacturing cost, as outsourcing has come down. Tax-rate for the quarter was 11%, and we expect it to remain at these levels for the next two years.

Asset-turnover ratio has dipped; more capex planned. Biocon's asset-turnover ratio has dropped to 0.9X in FY2007 from 1.9X in FY2006. This is beginning to resemble the asset-turnover ratio of other manufacturing companies. We estimate an additional capex of Rs7.5-10 bn over the next three years. Of this, Rs5 bn capex is planned for its third fermentation plant (in Vishakapatnam), which will largely be used for making crystals for the oral insulin product.

We understand that the new location has advantages in terms of availability of water, uninterrupted power supply and common effluent treatment facilities. We also understand that the capex will be staggered over a 5-year period. This plant is likely to be a large capacity insulin-manufacturing unit, assuming success in developing the oral insulin product. However this increases the project risk, as its second plant was set up at a total cost of about Rs5.5 bn and commercialized only in July 2006. This along with the first plant was supposed to take care of the need for insulin, statins, immunosuppressants and enzymes. We note that the normal capex for the company will be about Rs1 bn per annum. If staggered, then the project cost could even be met out of internal cashflows and debt, but an equity dilution cannot be ruled out.

The company has said that its second plant is being optimally used, though changes in product mix can yield better results. It has said that the new plant (four large fermentors; equivalent to 4X of the first plant) is also being used to make intermediates, which were earlier being outsourced. This has resulted in better profitability. We understand that at the second plant in Bangalore, there are operational challenges (lack of common effluent treatment plant, or likely power cuts in the future). However at this juncture, it might be better to focus on capital allocation and RoCE.

Biocon is focusing on both injectable and non-injectable forms of insulin. Its injectable product has already been launched in India, and registrations are ongoing in multiple countries. The company hopes to complete its EU filing by the year-end. Apart from intranasal insulin, it is also developing oral insulin, which has completed phase I trials and phase II trials are likely to begin in few months.

Maintain IL rating. We view Biocon as the dark horse in the sector, given its focus on biogenerics and innovative biotech medicines. Post the recent rally (20% up in last three months); the stock is trading at 20X FY2008 earnings expensive in our opinion. However the market seems to be attributing premium to a potential licensing deal of the oral insulin product (though unlikely in the near term). Our IL rating remains given the long-term potential in the company; including optionality on the innovation side. We have raised our target price to Rs460 (Rs370 earlier), on the back of earnings upgraded and roll over to FY2009.

Biocon - Results table, y/e March (Rs mn)

	Q4FY06	Q1FY07	Q2FY07	Q3FY07	Q4FY07	Q4, yoy growth %	FY2006	FY2007	FY07, yoy growth %	FY2008
Biopharmaceuticals	1570	1610	1830	1800	2040	30	6025	7280	21	8344
Enzymes	250	220	260	200	270	8	850	950	12	1093
Contract research	320	250	300	345	475	48	1006	1370	36	1877
License fees		40	100	120	0			260		430
Net Sales	**2140**	**2120**	**2490**	**2465**	**2785**	30	**7881**	**9860**	25	**11743**
Total Expenditure	1540	1580	1831	1690	1929	25	5593	7030	26	8311
- Inc/Dec in stock			(265)	(15)						
- Material & Power cost	1220	1190	1599	1230	1390		4339	5130		6056
- Staff cost	150	180	224	254	272		619	930		1174
- Other exp	170	210	272	220	267		636	970		1081
EBITDA	**600**	**540**	**659**	**775**	**856**	43	**2288**	**2830**	24	**3432**
Depreication	80	110	178	183	200		297	670		839
Net Interest Exp	10	20	22	25	24		18	90		128
Other Income	10	10	9	9	12		51	40		53
PBT	**520**	**420**	**469**	**576**	**645**	24	**2026**	**2110**	4	**2518**
Tax	50	40	22	40	68		243	170		285
Deferred Tax					0		63	0		0
Exceptional items							0	0		0
Minority interest	(1)	(10)	(7)	(17)	(26)		(20)	(60)		(40)
PAT	471	390	453	553	603		1740	2000		2273
Adj. PAT	**471**	**390**	**453**	**553**	**603**	28	**1740**	**2000**	15	**2273**
Ratios (%)										
Material & power (% of revenues)	57	56	54	49	50		55	52		52
Staff cost (% of revenues)	7	8	9	10	10		8	9		10
Other expenses (% of revenues)	8	10	11	9	10		8	10		9
EBITDA margin (%)	31	25	26	31	31		29	29		29
EBITDA margin, ex license fees (%)		24	23	28	31		29	27		27
Tax/PBT (%)	10	10	5	7	11		15	8		11
Adjusted net profit margin (%)	22	18	18	22	22		22	20		19

Pharmaceuticals

CADI.BO, Rs333	
Rating	OP
Sector coverage view	Neutral
Target Price (Rs)	385
52W High -Low (Rs)	400 - 231
Market Cap (Rs bn)	41.9

Financials

March y/e	2007E	2008E	2009E
Sales (Rs bn)	17.4	19.7	21.9
Net Profit (Rs bn)	2.2	2.7	3.2
EPS (Rs)	17.6	21.1	25.3
EPS gth	*45.0*	*20.2*	*19.7*
P/E (x)	18.9	15.8	13.2
EV/EBITDA (x)	11.9	10.1	8.7
Div yield (%)	1.3	1.6	1.9

Shareholding, December 2006

	Pattern	% of Portfolio	Over/(under) weight
Promoters	72.0	-	-
FIIs	4.7	0.0	(0.1)
MFs	6.0	0.3	0.1
UTI	-	-	(0.2)
LIC	6.8	0.3	0.1

Cadila Healthcare: Acquires a small company in Japan; market entry strategy

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- **Acquires small company in Japan; an entry strategy into the Japanese market**
- **Japanese generic market is currently US$3 bn in sales, and only 17% penetration**
- **Valuations are attractive; maintain OP**

Zydus Cadila has acquired a 100% stake in Nippon Universal Pharmaceutical Ltd. Nippon is a privately held company headquartered at Tokyo. Nippon reaches out to more than 4000 hospitals and clinics in Japan. We do not expect any significant addition from this small acquisition, but is likely to be relevant after 2010. Cadila's revenues will likely grow by 17% over the next two years and net profit by 32% compounded. We expect a strong 45% earnings growth in FY2007 on the back of 21% revenue growth and profits from the US subsidiary. We expect net profit growth of 20% in FY2008, on the back of 13% revenue growth. Our March 2008 DCF-based target price is Rs385, or 18X FY2008 earnings. The stock is trading at 16X FY2008 earnings, attractive in our view. Key risk is unfavourable pricing policy in the domestic market.

This acquisition is expected to provide a fillip to the company's operations in the Japanese market, which is highly complex and dominated by local pharma companies. The company hopes to add at least 5-6 products each year to Nippon's portfolio and build a basket of 40-50 products over the next 3 to 4 years. Cadila hopes to acquire new Marketing Authorisations (MA) from the market to cut short on development time. It also aims at exploring in-licensing agreements with other generic companies.

The Japanese generics market currently has sales of US$3 bn. Industry points to a tremendous growth potential, as generics constitute 5% of the Japanese pharma market in value terms and 17% by volume. The acquisition will provide access to a ready manufacturing and marketing base as well as a strong distribution reach.

Economy

Sector coverage view N/A

India's FY2007 US$57 bn trade deficit: In line, and doable ahead

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- **US$ 56.4 bn FY 2007 trade deficit; FY2008E US$ 63 bn**
- **Doable current account deficit: 1.6% of GDP FY07E; 1.3% FY08E**
- **Base effects, slower world GDP growth likely to moderate exports**
- **Slower national growth, stable oil prices to soften import demand**

India's merchandise trade deficit worked out to US$ 56.4 bn in FY2007, according to commerce minister Kamal Nath, broadly aligned to our US$ 58 bn expectations. The current account deficit is now forecast at a pretty doable 1.6% of GDP in FY2007E and 1.3% of GDP in FY2008E factoring in US$ 12 bn of defense imports. Although still robust, we conservatively expect some slow down in exports in FY2008E (US$146 bn lower than the commerce ministry's bullish US$ 160 bn projection) on account of the IMF's estimate of slower world GDP growth (4.9% 2007E from 5.4% 2006). We have assumed a somewhat higher Rupee at Rs44/USD in FY2008E than Rs45.1/USD in FY2007. We expect slower export growth to be compensated by relatively softer oil prices (US$60/bbl Dated Brent). Every US dollar increase in the India basket barrel price hits the current account deficit by about US $ 500-600 mn. We expect non-oil import demand to moderate with a slowdown in real GDP growth (8.3% in FY2008E from 8.9% in FY2007E).

Exhibit 1: Likely manageable FY2008E trade deficit

India's merchandise trade (US$bn)

Item	FY 2005F	FY 2006	FY2007	FY2008E
Exports	80.5	100.6	125.0	146.0
% growth				16.8
Imports	109.2	140.2	181.4	209.0
% growth				15.2
Oil	29.8	43.8	57.3	57.0
% growth				-0.5
Non-Oil	79.4	96.4	124.1	152.0
% growth				22.5
Trade Balance	-28.7	-39.6	-56.4	-63.0

Source : DGCI&S. F: Final.

Economy

Sector coverage view N/A

India's 2007 south-west monsoons: Varun, Venu and the ghost of 1997

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- **IMD's borderline 95% normal south-west monsoon forecast: Agriculture under a cloud**
- **Normal monsoons allow soft landing: 8.2% real GDP growth rate, 5% inflation**
- **Watch the skies: 100bp decline in agro GDP impacts overall GDP by 19bps**
- **Excessive tightening a risk: 5% higher agro prices impact WPI inflation by 190bps**

Varun, the rain god, holds the India story in his grasp. A normal south-west monsoon 2007 will likely douse agro price inflation—still running in double digits —and enable Governor Y. Venu Reddy to top off monetary tightening—with perhaps a last CRR hike ahead in case of large-scale forex intervention—at a reasonably neutral interest rate. Real interest rates—currently 7.25%—will likely close in on the 7.8% potential real GDP growth rate even at current CRR levels. As a matter of fact, the RBI will likely remain extremely wary until there is evidence that normal rains—our base case—are softening WPI inflation to 5% levels. A bad monsoon—sustaining high agro price inflation - will mount political pressure on the central bank to tighten monetary conditions to combat inflation—even if it be supply shocks—in face of a number of critical assembly polls in Gujarat, Madhya Pradesh, and Rajasthan next year. And the ghost of 1997 will have the last laugh.

2007 south-west monsoon forecasts: A lead of sorts, but clarity only by August. The Indian Metereological Department forecasts that India's June-September 2007 south-west monsoon would work out to 95% of the long-period average (LPA) with a 5% model error. A 10% deviation suggests deficient rainfall.

- The IMD's forecasts are scarcely infallible. Although it forecast 93% normal rains last year, the actual turned out to be 99%, albeit with a very skewed temporal and spatial distribution profile. This left behind a variety of agro shocks that now manifest in double-digit primary articles inflation.
- Other forecasts, including the one by the World Meterological Organization, are more optimistic about a favorable El Nina driving out possible El Nino worries.
- Exhibit 1 shows that the correlation between headline monsoon numbers and agro GDP growth is complicated by spatial and temporal distrbution (eg FY2007).
- At the same time, Exhibit 2 shows a reasonably clear relationship between agro GDP and inflation.

Importance of being South-west monsoon 2007. This essentially stems from the fear that persistence of agro shocks left behind by its 2006 predecessor could spark off excessive monetary tightening impacting growth.

- The direct impact of relatively insufficient rains on growth is not likely to be significant given the steady reduction in the share of agriculture in GDP.
- It is true that our 8.2% FY2008E real GDP growth rate depends on a robust 4% agricultural growth (Exhibit 3).
- Nevertheless, even at trend 2.5% real agro growth, overall GDP growth would per se still hold up at 7.9%.
- Far more importantly, our expected 1QFY08E inflation peak off is predicated on a reasonably benign rainfall, although we conservatively price in pressures in cotton and oilseeds (Exhibit 4).

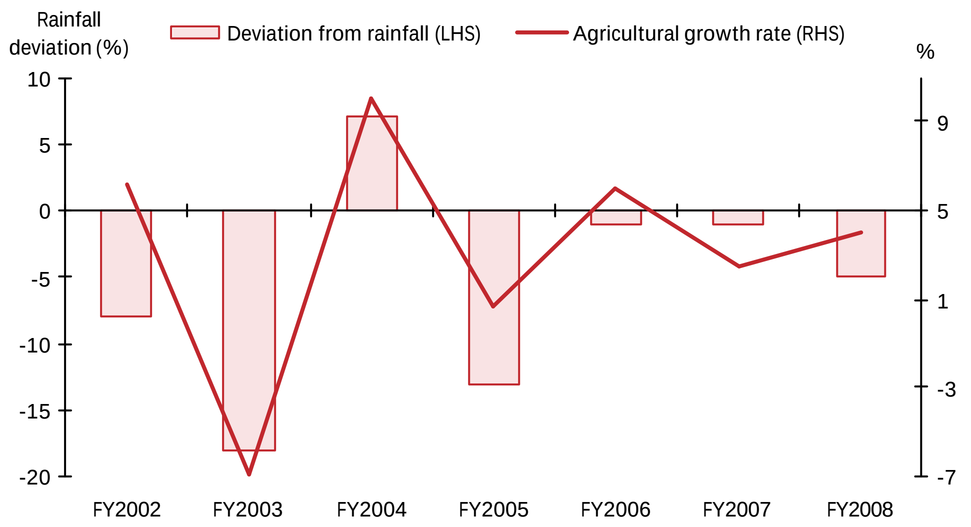
- Exhibit 5 shows that a further 5% increase in agro prices will push up overall WPI inflation to 6.9% from our benign base case 5% levels.
- Higher inflation will obviously put paid to possibilities of a monetary policy top off—perhaps with a final 50bp CRR hike in case of large-scale forex intervention—at a time real lending rates—currently 7.25%—are already approaching the potential 7.8% real GDP growth rate.
- The RBI will then come under tremendous political pressure to be 'seen' to be fighting inflation with a number of critical assembly polls—Gujarat, MP and Rajasthan – in which the ruling Congress directly locks horns with the opposition BJP.
- Unlike his predecessor Jalan, who used to resolutely ignore agro shocks in monetary policy, Governor Reddy ended up taking action at the peak of both the episodes of supply shock led inflation—mid-FY2004 and recently—during his tenure (Exhibit 6).
- Given that interest rates are already approaching neutral, further monetary tightening will clearly impact growth beyond the direct agro impact of slower agro growth (Exhibit 7).

Indian monsoon. India receives two monsoons: the major south-west (April-September) and the relatively minor north-west (October-November).

- The south-west waters the autumn rice-dominated kharif crop and the north-west the winter wheat-dominated rabi. Almost of equal size, the two crops account for about 15% of GDP.
- Overall rainfall, along with the temporal (especially, during the sowing month of July) and spatial distributions, determines the crop outcome.

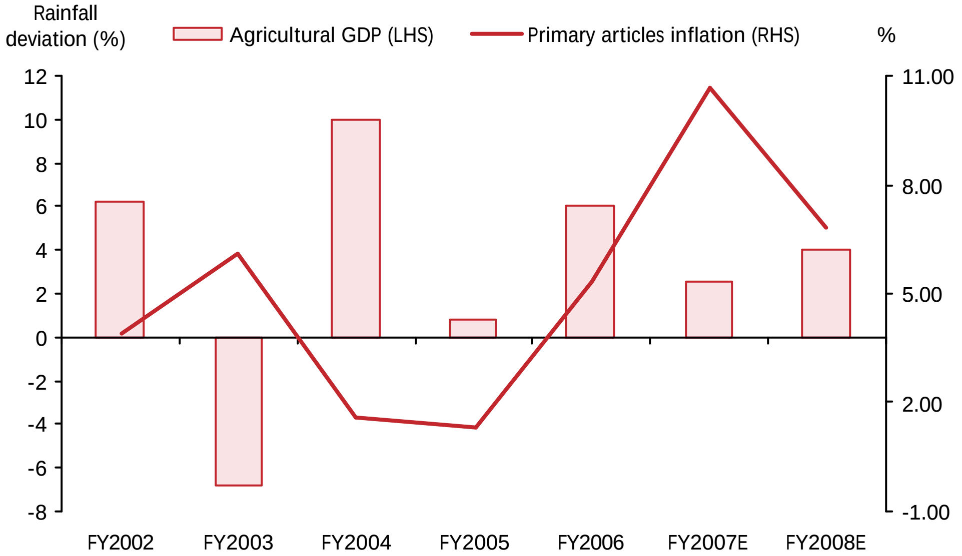
Exhibit 1: Temporal and spatial distribution of rainfall matters as much as overall rainfall

Agricultural GDP y-o-y growth rate, deviation from long period average rainfall during South-west monsoon



Source: Ministry of Agriculture, Kotak Institutional Equities.

Exhibit 2: A poor crop invariably pushes up inflation
Agricultural GDP growth rate, primary articles inflation rate (%)



Source: Ministry of Agriculture, BSE.

Exhibit 3: A 100bps change in agricultural GDP directly impacts overall GDP growth by 18bps
Real GDP at factor cost, and components (growth rates in %)

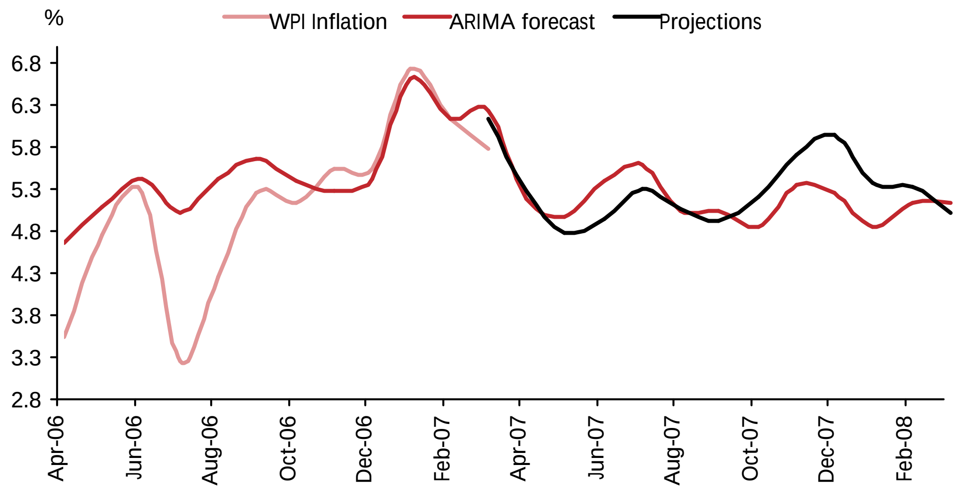
Item	Weight (2001-2006)	High growth phase (1994-97)	Low growth phase (1997-2002)	FY 2004	FY2005	FY2006	FY2007E	Normal monsoon FY2008E
Agriculture and allied activities	**21.8**	**4.6**	**2.1**	**10.0**	**(0.0)**	**6.0**	**2.5**	**4.0**
Industry	**19.6**	**10.8**	**4.1**	**6.0**	**8.4**	**8.0**	**10.0**	**7.9**
Mining and quarrying		5.2	4.2	3.0	7.6	3.4	3.5	3.5
Manufacturing		12.2	3.9	6.6	8.6	9.1	11.5	8.5
Electricity, gas and water supply		7.2	5.6	4.8	7.5	5.3	5.5	8.0
Services	**58.6**	**7.9**	**8.0**	**8.8**	**10.0**	**10.3**	**10.7**	**9.5**
Construction		4.6	7.0	11.9	14.1	14.2	10.0	7.5
Trade, hotels, transport, storage and communication		10.5	8.0	12.1	10.9	10.4	13.0	10.8
Financing, insurance, real estate and business services		6.9	7.5	5.6	8.7	10.9	10.0	10.0
Community, social and personal services		5.8	8.9	5.4	7.9	7.7	7.5	7.5
Real GDP at Factor Cost	**100.0**	**7.5**	**5.5**	**8.5**	**7.5**	**9.0**	**8.9**	**8.2**

Note: Real GDP shares and year-wise data since FY2004 on 1999-2000 base. # refers to CSO estimate.

Source: Central Statistical Organisation, Government of India and Kotak Institutional Equities.

Exhibit 4: Our expected inflation peak off is contingent on a normal monsoon

WPI, WPI (auto-regressive integrated moving average - ARIMA - forecast) y-o-y %



Source: Ministry of Industry, Government of India.

Exhibit 5: A 5% increase in agro prices increases overall inflation by 190bps, raises risks of excessive monetary tightening

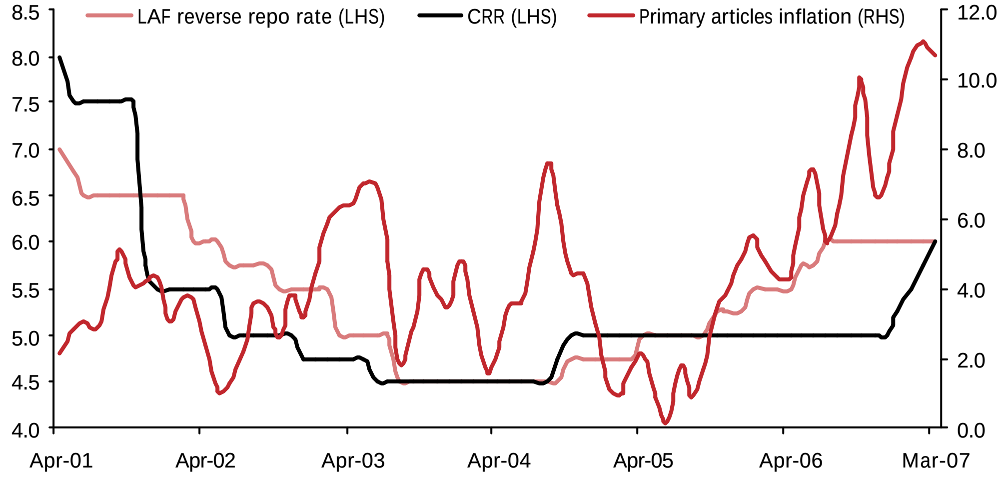
WPI, commodity-wise inflation (%)

		Inflation Rate (Year-on-year)					Normal monsoon	Sub-normal monsoon
Major group / Item	**Weight**	**FY 2003**	**FY 2004**	**FY 2005**	**FY 2006**	**FY2007**	**FY 2008E**	**FY 2008E**
All Commodities	**100.0**	**6.5**	**4.6**	**5.1**	**4.0**	**5.7**	**5.0**	**6.9**
Primary Articles	**22.0**	**6.1**	**1.6**	**1.3**	**5.3**	**10.7**	**6.8**	**11.8**
Food Articles	15.4	0.8	0.2	3.0	6.3	8.3	4.8	9.8
Fuel, Power, Light and Lubricants	**14.2**	**10.8**	**2.5**	**10.5**	**8.9**	**1.0**	**2.5**	**2.5**
Mineral oils	7.0	18.4	—	16.0	13.2	0.5	1.5	1.5
Manufactured Products	**63.8**	**5.1**	**6.7**	**4.6**	**1.5**	**5.8**	**5.2**	**6.7**
Food Products	11.5	8.7	9.7	0.4	2.4	6.4	6.9	11.8
Textiles	9.8	8.3	15.6	(12.7)	(0.6)	1.1	8.0	13.0
Chemicals and Chemical Products	11.9	4.2	0.1	3.9	1.8	2.9	3.0	3.0
Basic Metals, Alloys & Metal Products	8.3	6.6	22.1	17.1	(2.9)	11.0	5.0	5.0
Machinery and Machine Tools	8.4	0.5	3.1	7.1	3.3	8.0	8.0	8.0

Source: Ministry of Industry, Kotak Institutional Equities estimates.

Exhibit 6: Gov Reddy takes monetary policy action against supply shocks unlike his predecessor, Jalan

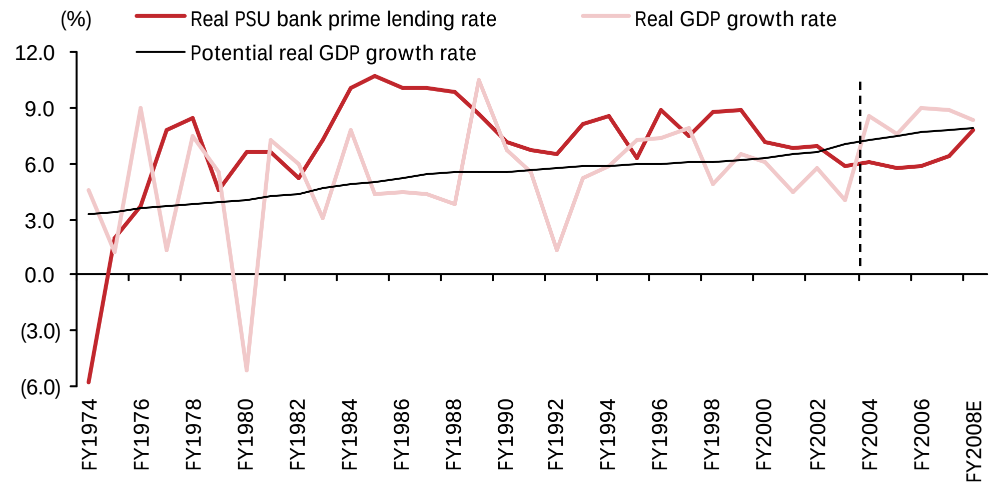
LAF reverse repo rate, primary articles inflation (%), cash reserve ratio (% of demand and time liabilities)



Source: Ministry of Industry.

Exhibit 7: Escalating risks of monetary tightening in case of a bad 2007 south-west monsoon

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



Source: CSO, RBI, Kotak Institutional Equities.

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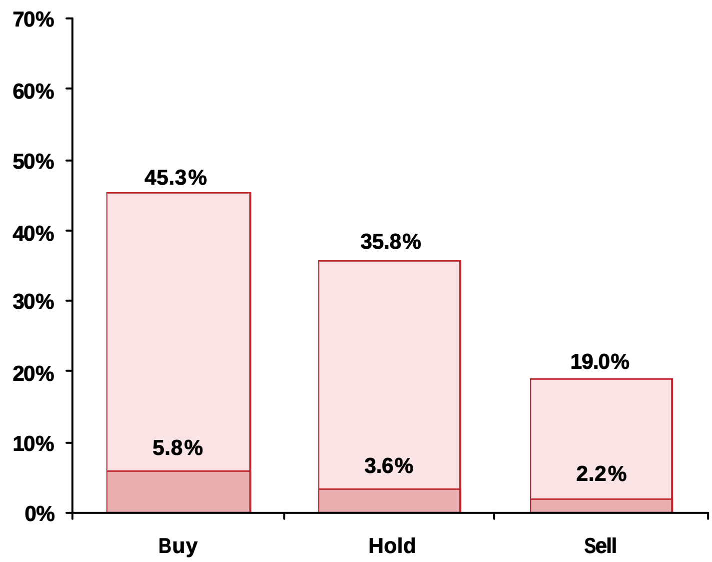

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Source: Kotak Institutional Equities. As of March 31, 2007

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