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Corporate

- Tata Steel has formed a seven-member integration committee to spearhead its union with Corus group. While Ratan Tata, chairman of the Tata group, heads the committee, three each are from Tata Steel and Corus group. The strategic committee’s mandate is to determine future strategic priorities of the enlarged group and drive integration where there is a clear business benefit. (ET)
- Tata AutoComp Systems (Taco) and French auto parts maker Valeo are believed to be in preliminary stages of discussions to acquire a stake in NYSE-listed ailing automotive supplier Visteon Corporation. Sources close to the development said the acquisition of a stake in Visteon, which was spun off from Ford Motor Company in 2005, would cost US$1.5-2 bn. (BS)
- Dr Reddy’s Laboratories is setting up two special economic zones (SEZs) - one each at Hyderabad and Visakhapatnam in Andhra Pradesh. While one SEZ would be exclusively for active pharmaceutical ingredients, the other would develop pharmaceutical products. (BS)

Economic and political

- The Centre’s move to allow the Pension Fund Regulatory and Development Authority (PFRDA) to put out expressions of interest for sponsoring a pension fund as an interim step has come under strong criticism from the Left parties. The Left parties have sought Prime Minister Manmohan Singh’s intervention in putting a stop to the process. (FE)

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

EQUITY MARKETS

		Change, %		
India	**18-May**	**1-day**	**1-mo**	**3-mo**
Sensex	14,303	0.0	2.9	0.8
Nifty	4,215	(0.1)	3.2	2.9
Global/Regional indices				
Dow Jones	13,557	0.6	4.6	6.4
Nasdaq Composite	2,558	0.8	1.3	1.6
FTSE	6,641	0.9	2.4	4.5
Nikkie	17,497	0.6	0.3	(2.3)
Hang Seng	20,956	0.2	1.9	1.5
KOSPI	1,615	0.2	5.3	11.3

Value traded - India

			Moving avg, Rs bn	
	18-May		**1-mo**	**3-mo**
Cash (NSE+BSE)	143.5		136.7	125.2
Derivatives (NSE)	298.4		279.5	405.0
Deri. open interest	585.0		566.4	620.6

Forex/money market

		Change, basis points		
	18-May	**1-day**	**1-mo**	**3-mo**
Rs/US$	40.7	-	(96)	(348)
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	8.2	4	11	15

Net investment (US$mn)

	17-May		**MTD**	**CYTD**
FIIs	252		1,257	40
MFs	149		238	(303)

Top movers -3mo basis

		Change, %		
Best performers	**18-May**	**1-day**	**1-mo**	**3-mo**
Balaji Telefilms	201	(0.3)	19.2	54.4
Thomas Cook	68	(3.4)	35.9	39.5
Reliance Cap	906	0.4	25.8	33.7
Moser Baer	457	5.8	37.6	32.2
BoB	281	(1.4)	22.2	24.7
Worst performers				
Bajaj Auto	2,287	(8.5)	(6.4)	(23.2)
Wipro	544	(0.2)	(4.7)	(18.6)
Polaris	174	1.5	(13.9)	(18.5)
Cipla	209	0.4	(11.0)	(17.8)
M&M	732	0.5	(1.5)	(17.7)

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Automobiles

TAMO.BO, Rs743	
Rating	OP
Sector coverage view	Attractive
Target Price (Rs)	925
52W High -Low (Rs)	975 - 651
Market Cap (Rs bn)	301.0

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	333.3	379.9	451.8
Net Profit (Rs bn)	17.8	19.8	22.5
EPS (Rs)	55.3	59.3	69.2
EPS gth	*23.6*	*7.2*	*16.7*
P/E (x)	13.4	12.5	10.7
EV/EBITDA (x)	7.7	6.9	5.8
Div yield (%)	2.2	2.2	2.2

Shareholding, March 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	33.4	-	-
FIIs	30.8	1.5	0.5
MFs	5.3	1.5	0.5
UTI	-	-	(1.0)
LIC	6.1	1.6	0.6

Tata Motors: 4Q operating performance disappoints

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- **4Q recurring EBITDA at Rs8.8 bn grows just 2% yoy; 12% lower than our estimates**
- **Recurring net profit grows 27% yoy boosted by below EBITDA-line items**
- **We maintain our EPS estimates, Outperform rating and target price of Rs925 for Tata Motors.**

Tata Motors reported 4Q recurring net profit at Rs5.3 bn - a 27% yoy growth but lower than our estimate of Rs5.6 bn. However 4Q recurring EBITDA at Rs8.8 bn was 12% lower than our estimate of Rs10.0 bn. Higher-than-expected other income and lower than expected interest costs and depreciation ensured that 4Q net recurring profit was just 4% lower than estimates. Tata Motors also had a foreign exchange gain of Rs602 mn in 4Q. As a result reported net profit came in at Rs5.8 bn ' a 26% yoy growth. Recurring EBITDA margins for 4Q at 10.7% declined 190 bps yoy and 130 bps qoq. We maintain our EPS estimates, Outperform rating and target price of Rs925 for Tata Motors.

4Q operating performance disappoints; RM pressures begin to hurt

A 17% volume growth in 4Q resulted in a 19% revenue growth but only a 2% recurring EBITDA growth for Tata Motors. 4Q EBITDA at Rs8.8 bn was 12% lower than our estimate of Rs10.0 bn. Recurring EBITDA margins for 4Q at 10.7% declined 190 bps yoy and 130 bps qoq. RM costs as a % of net sales rose 150 bps yoy and largely led to the margin decline. The sharp rise in steel prices in 4Q would have been a contributor to the same as Tata Steel buys a varying part of its steel requirements on spot price basis. EBITDA per vehicle declined 13% yoy in 4Q.

In our view, quarterly EBITDA margins for Tata Motors are unlikely to move up to erstwhile levels of ~ 12% in FY08. We however expect some sequential improvement as volumes of the 'Ace' start rolling out of the new plant at Uttaranchal, which enjoys excise and income tax benefits. In our opinion, given the weak market conditions especially in M&HCVs, Tata Motors will find it difficult to pass on raw material cost pressures to customers in the form of price hikes. Our estimates factor in a yoy drop in EBITDA margins for Tata Motors in FY2008.

Maintaining estimates, OP rating and target price of Rs925 for Tata Motors

We maintain our cons. EPS estimates for Tata Motors at Rs59.3 for FY08 and Rs69.2 for FY09. Our EPS estimates factor in domestic growth of 2.5% for M&HCVs, 10% for LCVs and 7.5% for cars and UVs in FY08. Tata Motors mentioned in its analyst meet that it is witnessing a slackening of implementation of the ban on overloading of trucks in some states. In our opinion, if this trend continues, there will exist downside risk to our FY08 growth estimate for M&HCVs.

In our opinion, while it is now more or less certain that FY2008 will see mid-single digit volume growth at best for Tata Motors in both CVs and PVs, FY2009 should be a better year if overall economic growth in India stays strong. We note that both GDP and industrial production data has remained strong in recent months. In our view, if freight demand stays strong, any over-supply situation in the CV industry will likely get resolved by 2HFY2008, paving the way for better growth in FY2009. Our estimates factor in a 12.5% domestic M&HCV growth for Tata Motors in FY2009. The recent strength witnessed in freight rates in March and April further gives us confidence that recovery could begin by the end of FY2008.

FY2009 – an important year for Tata Motors

In our view, Tata Motors will see several structural improvements and positive news-flow coming into play in FY09 in both its CV and car divisions. These include:

a) Launch of the new car platform to replace/supplement the 'Indica'

b) Launch of the new 'World truck' platform in both domestic and export markets

c) Launch of new cars from the Tata-Fiat joint venture

d) Launch of a new pick-up truck in Thailand by Tata Motors' 70% JV in that country as well as in the Indian market

e) Potential export of CVs in Latin America and Europe using IVECO's distribution network.

We see these launches providing upside risk to our FY09 estimates for the company and expect Tata Motors' to see a substantial de-risking in both its car and CV divisions in that year. We view the current weakness in the stock due to near-term growth concerns as an excellent opportunity to buy the stock from a one-year perspective or more. We maintain our Outperform rating on Tata Motors.

We maintain our target price for Tata Motors at Rs925, now based on FY2009. We value the core business at Rs653 at 7X FY2009 EV/EBITDA (8.5X FY2008 EV/EBITDA previously) equivalent to 12X FY2009 P/E. The reduction in our target multiple reflects rising risks to growth in both CVs and cars in the near-term. We value subsidiaries and embedded value at Rs272 per share.

Key takeaways from analyst meet

Tata Motors has increased it capital expenditure program to Rs120 bn over the next 4 years (Rs100 bn previously). This will comprise Rs80 bn for new product development and Rs40 bn for capacity expansions. The company plans to source Rs75 bn from internal accruals and plans to raise the balance Rs45 bn from issuance of suitable instruments in domestic/ overseas markets

Tata Motors: 4QFY2007 results

(in Rs mn)	4QFY06	3QFY07	4QFY07	% chg. qoq	% chg. yoy	Kotak estimates 4QFY07	% deviation	FY06	FY07	% chg.
Net sales	**68,828**	**68,252**	**82,068**	**20.2**	**19.2**	**84,130**	**(2.5)**	**206,022**	**274,048**	**33.0**
Operating costs	**(60,193)**	**(60,046)**	**(73,293)**	**22.1**	**21.8**	**(74,115)**	**(1.1)**	**(180,128)**	**(243,065)**	**34.9**
(Inc/Dec in Stock)	(4,137)	1,355	(2,936)	(316.7)	(29.0)	(1,601)	83.4	2,569	3,497	36.1
Raw Materials	(43,924)	(48,976)	(55,618)	13.6	26.6	(57,527)	(3.3)	(132,651)	(193,749)	46.1
Staff Cost	(3,141)	(3,581)	(3,647)	1.8	16.1	(3,615)	0.9	(11,431)	(13,678)	19.7
Other Expenditure	(8,991)	(8,845)	(11,092)	25.4	23.4	(11,371)	(2.5)	(38,615)	(39,134)	1.3
EBITDA	**8,635**	**8,206**	**8,775**	**6.9**	**1.6**	**10,016**	**(12.4)**	**25,894**	**30,983**	**19.7**
Other income	44	143	604	322.1	1,267.4	397	52.4	1,248	2,452	96.5
Interest costs	(692)	(852)	(598)	(29.8)	(13.6)	(943)	(36.6)	(2,264)	(3,131)	38.3
Depreciation & Amortization	(1,892)	(1,722)	(1,583)	(8.1)	(16.3)	(1,858)	(14.8)	(5,947)	(5,863)	(1.4)
Extraordinairies	381	1,312	599	(54.4)	57.3	-		2,005	1,291	(35.6)
PBT	**6,476**	**7,087**	**7,798**	**10.0**	**20.4**	**7,611**	**2.5**	**20,936**	**25,732**	**22.9**
Taxes	(1,895)	(1,956)	(2,031)	3.8	7.2	(2,017)	0.7	(5,245)	(6,597)	25.8
PAT	**4,581**	**5,132**	**5,767**	**12.4**	**25.9**	**5,594**	**3.1**	**15,691**	**19,135**	**21.9**
Adjusted PAT	**4,201**	**4,174**	**5,330**	**27.7**	**26.9**	**5,594**	**(4.7)**	**14,288**	**18,231**	**27.6**
Key ratios										
Volumes	147,635	141,393	172,082	21.7	16.6	172,082		453,821	578,991	27.6
Gross realizations (Rs/vehicle)	540,473	559,844	554,430	(1.0)	2.6	564,221		528,934	548,440	3.7
RM/Net sales (%)	69.8	69.8	71.3	1.6	1.5	70.3		63.1	69.4	6.3
RM/VOP (%)	67.9	70.4	70.3	(0.1)	2.4	69.7		63.6	69.8	6.2
EBITDA per vehicle (Rs)	58,486	58,037	50,994	(12.1)	(12.8)	58,204		57,057	53,511	(6.2)
EBITDA margin (%)	12.5	12.0	10.7	(1.3)	(1.9)	11.9		12.6	11.3	(1.3)
PAT margin (%)	6.7	7.5	7.0	(0.5)	0.4	6.6		7.6	7.0	(0.6)
Effective tax rate (%)	29.3	27.6	26.0	(1.6)	(3.2)	26.5		25.1	25.6	0.6

Source: Company data, Kotak Institutional Equities

Our SOTP target price for Tata Motors is Rs925

Value assigned to Tata Motors stand-alone at 7X FY09 EV/EBITDA & 12X FY09 P/E (Rs)	653
Value assigned to subsidiaries (Rs)	184
Embedded value in Tata Sons and Tata Steel	88
SOTP target price (Rs)	925

Source: Kotak Institutional Equities

Volume assumptions for Tata Motors, YE March 31

	2005	2006	2007E	2008E	2009E
Volumes (units)					
M&HCVs -domestic	129,256	127,696	172,900	177,223	199,376
M&HCVs -exports	5,931	8,249	11,136	13,363	16,036
M&HCVs-total	**135,187**	**135,945**	**184,037**	**190,586**	**215,412**
LCVs -domestic	60,757	87,226	125,780	138,358	155,653
LCVs -exports	13,478	21,383	24,163	26,579	29,237
LCVs-total	**74,235**	**108,609**	**149,943**	**164,937**	**184,890**
UVs -domestic	34,249	37,902	46,998	50,523	55,576
UVs -exports	2,783	1,881	2,633	2,897	3,186
UVs-total	**37,032**	**39,783**	**49,632**	**53,420**	**58,762**
Passenger cars	144,831	150,953	173,143	186,129	209,395
Passenger cars-exports	7,810	18,531	22,237	24,461	26,907
PVs-total	**152,641**	**169,484**	**195,380**	**210,590**	**236,302**
Total domestic sales	369,093	403,777	518,822	552,233	619,999
Total exports	30,002	50,044	60,170	67,300	75,366
Total vehicle sales	**399,095**	**453,821**	**578,991**	**619,533**	**695,365**
YoY growth (%)					
M&HCVs -domestic	25.2	(1.2)	35.4	2.5	12.5
M&HCVs -exports	31.7	39.1	35.0	20.0	20.0
M&HCVs-total	**25.5**	**0.6**	**35.4**	**3.6**	**13.0**
LCVs -domestic	23.9	43.6	44.2	10.0	12.5
LCVs -exports	112.9	58.7	13.0	10.0	10.0
LCVs-total	**34.1**	**46.3**	**38.1**	**10.0**	**12.1**
UVs -domestic	7.5	10.7	24.0	7.5	10.0
UVs -exports	25.1	(32.4)	40.0	10.0	10.0
UVs-total	**8.7**	**7.4**	**24.8**	**7.6**	**10.0**
Passenger cars	33.9	4.2	14.7	7.5	12.5
Passenger cars-exports	(12.2)	137.3	20.0	10.0	10.0
PVs-total	**30.4**	**11.0**	**15.3**	**7.8**	**12.2**
Total domestic sales	26.3	9.4	28.5	6.4	12.3
Total exports	36.7	66.8	20.2	11.9	12.0
Total vehicle sales	**27.0**	**13.7**	**27.6**	**7.0**	**12.2**

Source: Company data, Kotak Institutional Equities estimates

Financial Snapshot for Tata Motors

YE March 31, in Rs mn	2005	2006	2007E	2008E	2009E
Profit & Loss Account (Rs mn)					
Net sales	173,135	204,702	274,452	305,184	356,586
EBITDA	19,886	23,836	29,912	33,108	38,018
Other Income	2,718	2,569	3,832	4,516	5,303
Interest	(1,542)	(2,264)	(3,476)	(3,835)	(4,387)
Depreciation	(4,502)	(5,209)	(5,782)	(7,093)	(8,623)
PBT	16,561	18,931	24,486	26,697	30,312
Extraordinaries	(42)	1,603	1,291	-	-
Taxes	(4,150)	(5,245)	(6,643)	(6,866)	(7,797)
PAT	12,370	15,289	19,134	19,832	22,515
EPS (Fully diluted, Rs per share)	**34.8**	**44.7**	**55.3**	**59.3**	**69.2**
Balance Sheet (Rs mn)					
Equity capital	3,618	3,829	3,829	3,829	3,829
Reserves & surplus	43,149	57,767	70,620	84,368	101,003
Total borrowings	24,954	29,368	21,318	35,768	35,063
Total Liabilities	**71,721**	**90,965**	**95,767**	**123,965**	**139,895**
Total fixed assets	36,965	45,212	60,508	83,309	98,358
Cash	20,050	11,194	5,780	2,995	5,794
Net working capital (excl. cash)	(14,597)	14,265	6,685	6,528	4,610
Other long term assets	29,302	20,293	22,793	31,133	31,133
Total Assets	**71,721**	**90,964**	**95,766**	**123,965**	**139,895**
Cash Flow (Rs mn)					
Operating cash flow (excl. working capital)	14,670	19,388	21,689	23,530	27,453
Working capital changes	(2,700)	(28,862)	7,580	157	1,918
Capital expenditure	(8,793)	(17,720)	(22,000)	(31,000)	(25,000)
Investments	1,447	8,969	(2,500)	(8,340)	-
Other income	3,384	3,270	4,357	4,907	5,623
Free cash flow	8,008	(14,955)	9,126	(10,746)	9,994
Ratios (%)					
Sales growth	32.4	18.2	34.1	11.2	16.8
Ebitda growth	21.5	19.9	25.5	10.7	14.8
EPS growth	53.0	(0.5)	23.7	8.5	13.5
Ebitda margin	11.5	11.6	10.9	10.8	10.7
Debt/ Equity (X)	0.5	0.5	0.3	0.4	0.3
RoAE	28.2	27.5	27.6	24.4	23.3
RoACE	30.9	28.7	34.6	33.4	31.4

Source: Company data, Kotak Institutional Equities estimates

Pharmaceuticals

SUN.BO, Rs1013	
Rating	OP
Sector coverage view	Neutral
Target Price (Rs)	1,050
52W High -Low (Rs)	1196 - 640
Market Cap (Rs bn)	209.8

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	20.8	26.0	32.5
Net Profit (Rs bn)	7.7	9.0	11.3
EPS (Rs)	37.4	43.5	54.6
EPS gth	*35.0*	*16.4*	*25.4*
P/E (x)	27.1	23.3	18.6
EV/EBITDA (x)	28.0	19.6	14.7
Div yield (%)	0.7	0.7	0.8

Shareholding, March 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	68.3	-	-
FIIs	15.8	0.5	(0.2)
MFs	3.2	0.7	(0.0)
UTI	-	-	(0.7)
LIC	-	-	(0.7)

Sun Pharmaceuticals: Strong numbers once again

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- **Net profit is up 48% in Q4 and 35% for the year, ahead of our estimate**
- **Revenue growth was 34% for the quarter and 30% for the year**
- **We will review estimates post earnings call today**
- **We have an OP rating**

Sun has reported a great quarter, as all businesses are doing well. Net profit for the year is up 35% on the back of 30% increase in revenues and 39% increase in EBITDA. We will review our estimates post earnings call today. Broadly, we expect Sun to deliver over 20% earnings growth over the next 3-5 years. We thus think that rich valuations are likely to sustain as the company reports consistent growth, amongst the few in the sector. We also believe that the company's generics pipeline can spur positive surprises. Negative surprises could come from increase in tax-rate. For the year, there has been a tax-writeback. While most of the profits are currently coming from tax-free units and Caraco (which is also not paying taxes), any adverse regulation on minimum tax could be a risk. Maintain OP.

All businesses are growing and this is an encouraging trend

- Domestic formulation sales have grown by 23% for the year and constitute 53% of sales.
- For Q4, domestic formulations grew by a strong 46% (surprisingly Q4 is the best quarter this year). We hope to get more clarity during the call.
- Sun Pharma now holds 3.2% share in the domestic formulations market, as per latest IMS ORG report.
- Caraco (US subsidiary) constitutes 23% of sales and grew by 41% in dollar terms
- Formulation exports grew by 50%, and constitutes 9% of sales
- APIs constitute 15% of sales and grew by 19%

Caraco (US subsidiary) has reported sales of US$117 mn, up 41% yoy. Between Sun and Caraco, 34 products are approved. A total of 16 ANDAs were filed during the quarter. With these 77 products await FDA approval (including 7 tentative approvals). Noteable is an approval and launch of Phenytoin (complex product) and a tentative approval for Amifostine injection (~ $100 mn product) in which the company is the first-to-file a patent challenge. We believe the company could spur positive surprises from its pipeline.

EBITDA margin is up 190 bps to 32.7%

- We note that costs for the full year include innovative research
- R&D cost for the year has increased by 66% to Rs2.6 bn
- Material cost is down 250 bps to 28.1%. This is the lowest material cost for companies in our coverage universe. Torrent (IL rated) would come close to this number, if we remove its contract manufacturing business.
- Staff cost has moved up sharply this year, up 81% to Rs2.55 bn. We think this has primarily increased owing to the team that came in with the company's last acquisition (Able Labs in the US).
- Other expenses have moved up by 39% this year.

Company paid cash tax of 1% - as two key components of PBT are not taxable

- 71% of company's PBT is come from Sun Pharma Industries, which does manufacturing in tax free zones (for domestic formulation sales)
- 22% of PBT is from Caraco, which has accumulated losses and does not need to pay any tax
- We note that few other subsidiaries are making losses (relating to recent acquisitions)
- We note that the company spent Rs2.55 bn on research (Rs1.6 bn was on standalone basis). So if we add the standalone research spend back to PBT, and then take a 150% weighted deduction on the R&D spend — the company needs to pay tax only on Rs345 mn
- The company paid current tax of Rs78 mn (23% of the above number), which was negated by a deferred tax asset of Rs145 mn

Ours is a very simple way of looking at the tax calculation, but this broadly gives a fair idea of the company's low tax payout. We estimate that the company would have a cash balance of US$475 mn, which will likely be used for acquisitions.

Sun Pharma - results table (Rs mn)

	Q4FY06	Q1FY07	Q2FY07	Q3FY07	Q4FY07	yoy growth %	FY2006	FY2007	yoy growth %
Gross Sales	4,288	5,348	5,642	5,658	5,725	34	17,372	22,373	29
India	2,278	3,139	3,114	3,168	3,265	43	10,414	12,686	22
Overseas	2,010	2,209	2,528	2,490	2,459	22	6,958	9,687	39
- Indirect tax	322	362	413	395	412		1,427	1,581	
% of sales	14	11.5	13.3	13.2	12.6		13.7	12.5	
Net Sales	**3,966**	**4,987**	**5,229**	**5,263**	**5,313**	34	**15,945**	**20,792**	30
Total Expenditure	**2,996**	**3,176**	**3,521**	**3,530**	**3,768**	26	**11,040**	**13,995**	27
- Inc/Dec in stock	(934)	(249)	(203)	(294)	(442)		(1633)	(1188)	
- Material cost	2195	1,671	1,782	1,851	1796		6,505	7038	
- Staff cost	517	620	616	658	664	29	1416	2558	81
- R&D cost							1534	0	
- Other exp	1219	1,134	1,326	1,315	1749		3218	5587	
EBITDA	**969**	**1,811**	**1,708**	**1,733**	**1,545**	59	**4,905**	**6,798**	39
Other operating income					0		12	0	
Depreciation	189	202	204	212	201		610	818	
EBIT	**781**	**1,610**	**1,504**	**1,522**	**1,344**	72	**4,307**	**5,980**	39
Net Interest Income	367	239	262	250	202		869	953	
Other Income	330	35	140	386	740		793	1300	
PBT	**1,477**	**1,883**	**1,906**	**2,157**	**2,286**	55	**5,969**	**8,233**	38
Current Tax	113	2	32	11	5		83	78	
Deferred Tax			(54)	(40)	(23)		157	(145)	
Less: Minority Interest	(65)	115	64	198	183		(3)	559	
Rep. PAT	**1,429**	**1,767**	**1,864**	**1,989**	**2,121**		**5,733**	**7,741**	
Adj. PAT	**1,429**	**1,767**	**1,864**	**1,989**	**2,121**	48	**5,733**	**7,741**	35
Revenue mix (Rs mn)									
India	**2,278**	**3,139**	**3,114**	**3,168**	**3,265**	43	**10,411**	**12,671**	22
% of sales	53	59	55	56	57		60	57	
Formulations	2,132	2,918	2,834	2,935	3,122	46	9,596	11,809	23
Bulks	144	221	280	227	139	(4)	815	862	6
Others	2			6	4				
International	**2,010**	**2,209**	**2,528**	**2,490**	**2,459**	22	**6,924**	**9,652**	39
% of sales	47	41	45	44	43		40	43	
Caraco (USA)	1,157	1,139	1,302	1,302	1,466	27	3,651	5,208	43
Formulations	371	463	494	625	500	35	1,385	2,082	50
Bulks	464	608	732	556	479	3	1,888	2,362	25
Others	18			7	15				
Total revenues	**4,288**	**5,348**	**5,642**	**5,658**	**5,725**		**17,335**	**22,322**	
Operating ratios (% of net sales)									
Material cost	31.8	28.5	30.2	29.6	25.5		30.6	28.1	
Staff cost	13.0	12.4	11.8	12.5	12.5		8.9	12.3	
Other expenses	30.7	22.7	25.4	25.0	32.9		20.2	26.9	
EBITDA	24.4	36.3	32.7	32.9	29.1		30.8	32.7	
Net margin	36.0	35.4	35.6	37.8	39.9		36.0	37.2	

Pharmaceuticals

REDY.BO, Rs666	
Rating	U
Sector coverage view	Neutral
Target Price (Rs)	620
52W High -Low (Rs)	840 - 579
Market Cap (Rs bn)	111.7

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	65.1	52.9	60.6
Net Profit (Rs bn)	11.0	5.0	5.8
EPS (Rs)	65.7	30.0	34.4
EPS gth	*670.0*	*(54.0)*	*15.0*
P/E (x)	10.1	22.2	19.4
EV/EBITDA (x)	7.9	12.9	11.5
Div yield (%)	0.6	0.6	0.8

Shareholding, March 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	25.2	-	-
FIIs	44.1	0.9	0.5
MFs	6.4	0.8	0.4
UTI	-	-	(0.4)
LIC	7.9	0.9	0.5

Dr. Reddy's Laboratories: Short-term opportunities constitute 80% of earnings

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- **FY2007 results are standout; with pre-exceptional net profit of Rs11 bn**
- **However short-term opportunities comprised 80% of PAT**
- **We estimate 54% dip in FY2008 earnings; 26% growth excluding short-term opportunities**
- **Stock is likely to open firm, but upside is likely capped as focus shifts to Q2 and beyond.**

Dr. Reddy's (RDY) reported pre-exceptional net profit of Rs5 bn in Q4 versus our estimate of Rs1.6 bn. Strong performance in the US market (though short-term opportunities) has helped the company beat estimates. The company has reported net profit of Rs11 bn for FY2007, of which we estimate that 80% is from short-term opportunities. Our EPS for FY2008 EPS is Rs30, or a drop of 54%. Stock is likely to open firm, but upside is likely capped as focus shifts to Q2 and beyond. Consensus EPS is likely to trend down, and visibility on FY2009 is low. Maintain U rating, with March 2009 DCF based target price of Rs620.

Short-term opportunities comprised 80% of FY2007 PAT. These include authorized generics of Simvastatin & Finasteride, Ondansetron exclusivity, generic Fexofenadine and API (Sertraline and Rabeprazole) sales to Teva. It also includes research income booked under the ICICI Venture deal. While two products (Ondansetron and Fexofenadine) are likely to continue for some more time, contribution from these will shrink sharply from Q2.

Expect 54% dip in FY2008 earnings (or 26% earnings growth excluding short-term opportunities from both years). For FY2008, we estimate an 19% dip in turnover and 54% dip in net profit. The dip in turnover is owing to short-term opportunities (like authorized generics/exclusivities), excluding which revenue growth would be 10% and net profit growth would be 26% (with a core EPS of Rs17). For FY2009, we estimate 15% growth in revenues and 15% growth in net profit.

Betapharm profitability likely to be impacted in the short-term. In Germany, company's revenues were Rs788 mn in Q4 and Rs8 bn for the year (with operating margin of about 21%). For FY2008, we have modeled sales of Rs9.2 bn, 15% growth.

Q4 revenues were impacted by supply side issues, which have as per the management been resolved. The company now has an agreement with Hexal (large supplier to betapharm) to source products from third-party. Hexal in turn has been offered a higher price for its supplies (details not available). This will have a short-term impact on profitability, but the management indicated that benefits will start flowing by the year-end. The company hopes to move its key products to Indian plants, which shall result in increased margins.

During Q4, the company took an impairment charge of Rs1.6 bn pertaining to betapharm. Insurers (in Germany) are trying to reduce generic prices by opting for preferred suppliers, whose brands will likely be recommended at both the prescription and pharmacy level. This is a negative for pricing, and might result in more charges going forward. RDY too is entering into contracts with insurance companies.

US generic sales likely to drop to Rs7.1 bn in FY2008. US generic sales were Rs23.6 bn (Rs5.6 bn in Q4). Four short-term product opportunities (Ondansetron, Fexofenadine, Simvastatin and Finasteride) added Rs20.8 bn (Rs4.25 bn in Q4). For FY2008, we have assumed US generic sales of Rs7.1 bn, which will still include Rs1.5 bn from short-term opportunities (Fexofenadine till H1 and Ondansetron exclusivity).

The company is targeting 80% of patent expiries in the US market. Pipeline comprises of 69 ANDAs (US$56 bn innovator sales), with 18 first-to-file opportunities (US$10 bn innovator sales).

The company's core businesses in emerging economies are doing well. Branded formulations business grew by 24% in FY2008, and constituted 26% of FY2007 revenues (excluding authorized generics and exclusivity products). Key markets of India and Russia grew by 22%, and constitute 80% of segment sales. We have modeled 18% growth in branded formulations over the next two years. Portfolio expansion is happening rapidly and it has also launched out two biosimilars in India (GCSF, Rituximab).

APIs too have done well, growing by 44% in FY2007. APIs constitute 25% of total sales (excluding authorized generics and exclusivity products), and DRL is extremely strong in the APIs business. Segment gross margins were 39% for the year, boosted by sale of Sertraline and Rabeprazole, which we estimate had gross margin of 75%. This we believe is a short-term opportunity. We estimate normalized margins of 28% in the API business. We have modeled a 2% dip in API sales to Rs11.6 bn in FY2008.

Margins likely to rise in FY2008; stock seems to be factoring in more than base numbers. We expect gross margins of 50% in FY2008 versus management guidance of 50%-52%. SG&A cost has risen sharply, post acquisition of betapharm. We estimate SG&A cost at 30%, inline with management guidance. We have assumed that research cost (excludes R&D related income) will rise from Rs3.3 bn to Rs4 bn (7.6%) in FY2008. We estimate operating margin of 13.4% in FY2008, versus 22% in FY2007. We model an EPS of Rs30 in FY2008 and Rs34.4 in FY2009.

Dr. Reddy's - results table (Rs mn)

	Q4FY06	1QFY07	2QFY07	3QFY07	4QFY07	yoy growth %	FY2006	FY2007	yoy growth %	FY2008E
Net revenues	**6,974**	**14,049**	**20,039**	**15,434**	**15,573**	123	**24,267**	**65,095**	168	**52,927**
Cost of revenues	4,036	7,960	11,750	8,690	5,818		12,417	34,220		26,452
Gross Profit	2,938	6,089	8,288	6,744	9,755	232	**11,850**	30,875	161	26,475
Operating expenses	3,164	4,425	4,813	4,766	4,821		10,986	18,911		20,940
R&D	722	691	743	832	937	30	2,537	3,289	30	4,013
S,G&A	2,279	3,346	3,667	3,604	3,433	51	8,029	14,051	75	15,668
Amortisation	162	388	402	330	451		420	1,571		1,259
Research Income	44	158	341	156	85		384	826		300
Operating Income	**(182)**	**1,822**	**3,816**	**2,134**	**5,019**		**1,248**	**12,790**	925	**5,836**
Forex loss/ (gains)	18	74	(55)	49	(205)		126	(137)		0
Other expenses/(income)	49	205	319	221	(88)		(534)	661		(86)
Equity in loss of affiliates	48		21	13	29		88	63		60
PBT	**(297)**	**1,543**	**3,531**	**1,852**	**5,283**		**1,568**	**12,203**	678	**5,862**
Tax	(62)	208	737	(27)	260		258	1,177		821
Minority Interest	1	0	(4)	0	1		(4)	0		0
Pre-exceptional PAT	**(236)**	**1,335**	**2,798**	**1,879**	**5,022**		**1,313**	**11,026**	740	**5,041**
Non-recurring charges/(income)		(63)			1,770		(320)	1,703		0
Reported PAT	(236)	1,398	2,798	1,879	3,252		1,633	9,323	471	5,041
EPS (Rs, pre-exceptional)							7.8	65.7		30.0
Ratios (% of net sales)										
Gross margin	42.1	43.3	41.4	43.7	62.6		48.8	47.4		50.0
R&D	10.4	4.9	3.7	5.4	6.0		10.5	5.1		7.6
S,G&A	32.7	23.8	18.3	23.4	22.0		33.1	21.6		29.6
Operating margin	(2.6)	13.0	19.0	13.8	32.2		5.1	19.6		11.0
Tax rate (% of PBT)	21.0	13.5	20.9	(1.5)	4.9		16.5	9.6		14.0
Net margin	(3.4)	9.5	14.0	12.2	32.2		5.4	16.9		9.5

Utilities

LAIN.BO, Rs167	
Rating	OP
Sector coverage view	Attractive
Target Price (Rs)	204
52W High -Low (Rs)	276 - 137
Market Cap (Rs bn)	37.0

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	16.4	29.8	58.9
Net Profit (Rs bn)	1.9	3.1	5.5
EPS (Rs)	8.7	14.0	24.9
EPS gth	*65.3*	*71.5*	*91.4*
P/E (x)	19.2	11.9	6.7
EV/EBITDA (x)	13.4	16.0	11.0
Div yield (%)	-	-	-

Shareholding, March 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	75.0	-	-
FIIs	8.8	0.1	0.1
MFs	1.4	0.0	0.0
UTI	-	-	-
LIC	1.5	0.0	0.0

Lanco Infratech: Investments in power start raking in revenues; Retain Outperform

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- **Maintain Target price of Rs204/share, retain Outperform rating**
- **Consolidated Net Sales for the quarter increased 4X yoy to Rs4.8 bn.**
- **Construction business has an Order book of Rs52 bn**

Lanco reported consolidated sales of Rs4.8 bn, EBITDA of Rs1.3 bn and net profit of Rs0.5 bn for the fourth quarter of FY2007. Our target price of Rs204 offers a significant upside from the current market price of Rs165, hence we retain our outperform rating for the stock. Our SOTP value comprises Rs110/share for the power project portfolio derived using DCF-to-equity at 11% cost of equity; Rs44/share as the NPV of the real estate projects; and Rs50/share as NPV of the cash flows of the construction business. We would await appropriate triggers to include the value Sasan Ultra Mega Power Project.

Consolidated Net Sales for the quarter increased 4X yoy to Rs4.8 bn. Lanco reported consolidated net sale of Rs4.8 bn for the fourth quarter (Rs0.9 bn 4QFY2006) which was a fourfold increase. This increase can be largely attributed to the revenues contributed by the two power subsidiaries viz. Lanco Kondapalli and Aban Power in which the company increased its investment to 59% and 51% respectively. The power business contributed Rs 2.7 bn in revenues and Rs0.5 bn in EBIT while the construction business contributed Rs2.1bn in revenues and Rs0.4 bn in EBIT respectively.

Construction business has an Order book of Rs52 bn The current outstanding order book stands at Rs52 bn for the construction business. Out of the Rs52 bn, 95% of the orders are internal to the company. These include Rs35 bn for the Nagarjuna project and Rs9 bn for the Amarkantak project. In terms of the real estate development business SEZ notification has been received for the Hyderabad IT park while the Vizag property still awaits government order for handing over the site to the company.

Lanko Infratech (Consolidated), Quarterly performance, March yearends (Rs mn)

	yoy			qoq		
	Mar-07	Mar-06	% change	Mar-07	Dec-06	% change
Net sales	**4,895**	**963**	**408**	**4,895**	**4,293**	**14**
Construction Generation and Operating Expenses	3,276	868	278	3,276	3,241	1
Personnel costs	77	9	760	77	63	22
Other expenses and provisions	231	5	4,183	231	43	443
Total expenses	**3,584**	**882**	306	**3,584**	**3,347**	7
EBITDA	**1,311**	**81**	**1,522**	**1,311**	**947**	**39**
Depreciation	180	4		180	181	
EBIT	1,131	77		1,131	766	
Other income	111	5		111	214	
Net interest	224	13		224	226	
PBT	**1,018**	**68**	**1,401**	**1,018**	**753**	**35**
Tax	156	8		156	67	
Deferred tax	60	(2)		60	(50)	
Profit before Minority Interest	**802**	**61**	**1,211**	**802**	**736**	**9**
Minority Interest	**234**	**(24)**		**234**	**169**	
Net Profit	**568**	**85**	**569**	**568**	**567**	**0**
EBITDA margin (%)	27	8		27	22	
Effective tax rate (%)	21	10		21	2	
Segment Revenues						
Construction	2,168	617		2,168	1,289	
Power	2,718	9	31,725	2,718	2,983	(9)
Property Development	-	-		-	-	
Others	9	337	(97)	9	22	(58)
Net revenues	**4,895**	**963**		**4,895**	**4,293**	
EBIT						
Construction	441	22		441	164	
Power	518	5		518	704	
Property Development	(10)	1		(10)	(14)	
Others	(1)	58		(1)	26	
Total	**948**	**87**		**948**	**879**	
EBIT Margin (%)						
Construction	20	7		20	13	
Power	19	33		19	24	
Property Development	NA	NA		NA	NA	
Others	(10)	20		(10)	118	

Source: Company data, Kotak Institutional Equities.

Lanko Infratech (Standalone), Quarterly performance, March yearends (Rs mn)

	yoy			qoq		
	Mar-07	Mar-06	% change	Mar-07	Dec-06	% change
Net sales	**2,172**	**990**	**119**	**2,172**	**1,313**	**65**
Construction Generation and Operating Expenses	1,568	866	81	1,568	1,007	56
Personnel costs	38	5	594	38	30	28
Other expenses and provisions	127	9	1,268	127	22	486
Total expenses	**1,733**	**881**	97	**1,733**	**1,058**	64
EBITDA	**440**	**109**	**302**	**440**	**255**	**72**
Depreciation	15	4		15	4	
EBIT	425	105		425	251	
Other income	30	5		30	62	
Net interest	59	13		59	13	
PBT	**396**	**96**	**312**	**396**	**300**	**32**
Tax	94	20		94	20	
Deferred tax	60	(2)		60	(2)	
Net Profit	**243**	**78**	**212**	**243**	**281**	**(14)**
Extraordinary		39			39	
Reported Net Profit	**243**	**39**		**243**	**242**	
EBITDA margin (%)	20	11		20	19	
Effective tax rate (%)	39	19		39	6	
Segment Revenues						
Construction	2,150	685		2,150	1,289	
Power	5	9	(40)	5	5	9
Property Development	18	16		18	19	
Others	-	280	(100)	-	-	NA
Net revenues	**2,172**	**990**		**2,172**	**1,313**	
EBIT						
Construction	412	42		412	230	
Power	(7)	3		(7)	(5)	
Property Development	18	16		18	19	
Others	72	1		72	24	
Total	**495**	**61**		**495**	**269**	
EBIT Margin (%)						
Construction	19	6		19	18	
Power	(134)	32		(134)	(107)	
Property Development	100	100		100	100	
Others	NA	0		NA	NA	

Source: Company data, Kotak Institutional Equities.

Banking

FED.BO, Rs278	
Rating	OP
Sector coverage view	Neutral
Target Price (Rs)	340
52W High -Low (Rs)	283 - 137
Market Cap (Rs bn)	23.8

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	10.2	10.7	12.2
Net Profit (Rs bn)	2.9	3.2	3.5
EPS (Rs)	34.2	37.1	41.3
EPS gth	*30.0*	*8.5*	*11.5*
P/E (x)	8.1	7.5	6.7
P/B (x)	1.7	1.4	1.2
Div yield (%)	1.4	2.7	3.0

Federal Bank: Performance exceeds estimates, retain OP

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- **Federal Bank reported a PAT of Rs992 mn for 4QFY07'a growth of 96% yoy and 56% higher than our estimates**
- **Strong operational performance and strengthening of balance sheet are the key features of the results**
- **Maintain OP rating and price target of Rs340.**

Federal Bank reported a PAT of Rs992 mn for 4QFY07'a growth of 96% yoy and 56% higher than our estimates. Federal Bank's numbers are distorted marginally by merger of Ganesh Bank, which was effective from 2 September 2007, and reflected in 4QFY07. Strong performance at the operational level, one-off item of recovery of written off account of Rs460 mn and lower effective tax rate were the prime reasons for the divergence in our estimates vis-'-vis the actual performance. Other positive feature of this year's financial performance of Federal Bank has been the provisions (explained later in the note) to strengthen its balance sheet. We have marginally tweaked our estimates for FY2008 and FY2009 post the results. Valuations of 6.7X PER and 1.2X APBR FY2009 are attractive for a bank with a favorable operational performance outlook over the next two years (RoE likely to be 18-19%). We re-iterate our positive stance on the stock and maintain our target price of Rs340.

NII growth remains strong. Net interest income (NII) for Federal Bank in 4QFY2007 was Rs2.3 bn growth of 32% yoy and 14% ahead of our estimates. Bank received a one-off interest income of Rs110 mn on the CRR balances in 4QFY2007, stripped of this income the NII growth was 26% yoy. Lower than expected interest cost and higher investment income compared to our estimates led company reporting higher NII than expected. Federal Bank loan book grew by a healthy 27%yoy to Rs149 bn, within which retail segment recorded a growth of 45%yoy. Federal Bank took recourse to bulk deposits to meet its fund requirements in 4QFY07, which led to the CASA ratio declining to 25.6% as of March 2007 from 28.4% as of December 2006. Given the higher interest rates on such deposits, we have assumed a decline in spread estimates for FY2008 and FY2009 of close to 20-30bps from the reported FY2007 results.

Other income boosted by recovery from written off accounts. Federal Bank made recoveries from written off accounts of close to Rs460 mn in 4QFY07(Rs260 mn in 4QFY06), which led to the other income at the bank growing by a hefty 51% yoy. Other income growth net of recovery from written-off accounts was a more moderate 36% yoy.

Additional provisions made to strengthen the balance sheet. Federal Bank made a provision of Rs193 mn for the depreciation loss on its AFS portfolio in 4QFY07. Bank took a MTM hit on its AFS portfolio with the closing prices as on April 3, 2007 instead of March 31,2007 as is the usual policy. It is to be noted that RBI announced monetary measures of hiking CRR to 6.5% and increasing repo rate to 7.75% on March 30, 2007. Bank management in its discretion felt that it would be prudent to value its AFS investments on April 3,2007 than March 31,2007.

Federal Bank made the following additional provisions during FY2007: (a) It booked the entire VRS expense of Rs143 mn in 2QFY07—regulations allow the bank to capitalize these expenses and provide it over a five year period, (b) Provision of Rs233 mn – merger of Ganesh Bank of Kurundwad with itself led to excess liabilities over assets, (c) Provision of Rs284 mn was made towards employee benefits under the revised AS-15 guidelines—regulations allow for adjustment against the equity of the bank.

CAR remains comfortable. Federal Bank had a CAR of 13.4% as of March 2007, with a Tier I ratio of 8.96%. Bank has Investment Fluctuation Reserves (IFR) of Rs1.7 bn, which is currently treated as Tier II capital. Further, 5% of PAT are appropriated by the bank towards the IFR as a contingency against adverse interest rate movements on its investment book. Other banks under our coverage consider IFR balances as part of Tier I capital starting FY2006.

Federal Bank

	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	% chg	4Q07KS	Actual Vs KS
Interest earned	3,625	3,903	4,083	4,337	4,441	5,313	36.1	5,212	1.9
Interest/discount on advances/bills	2,371	2,616	2,786	3,010	3,200	3,818	45.9	3,868	(1.3)
Income on Investments	1,199	1,207	1,151	1,176	1,207	1,290	6.9	1,063	21.4
Interest on balances with RBI and other inter bank funds	49	42	137	142	25	134	216.5	281	(27.4)
Others	6	38	8	9	9	70	86.1		
Interest expended	2,130	2,181	2,497	2,662	2,658	3,033	39.1	3,210	(5.5)
Net interest income	**1,494**	**1,722**	**1,586**	**1,675**	**1,784**	**2,280**	**32.4**	**2,002**	**13.8**
Other Income	484	697	543	726	545	1,054	51.1	758	39.0
Total income	1,978	6,731	4,625	5,063	2,328	3,333	(50.5)	2,760	20.8
Operating Expenses	853	992	991	1,011	973	1,086	9.4	1,154	(5.9)
Payments to and provisions for employees	518	608	649	656	602	697	14.7	696	0.2
Other operating expenses	334	385	342	355	371	389	1.0	458	(15.1)
PBT before provisions	**1,126**	**1,427**	1,137	**1,390**	**1,355**	**2,247**	**57.5**	**1,606**	**39.9**
Other Provisions and Contingencies	199	813	559	526	196	867	6.6	541	60.2
NPL	51	1,536	245	377	197	75	(95.1)	263	(71.7)
PBT	**927**	**614**	**578**	**864**	**1,159**	**1,381**	**124.7**	**1,066**	**29.5**
Provision for Taxes	211	107	176	170	321	388	262.5	433	(10.4)
NET PROFIT	**716**	**507**	402	695	**838**	**992**	95.6	**632**	56.9
Tax rate (%)	23	17	30	20	28	28		41	
Deposit book details									
Desposits (Rs bn)	164	179	NA	NA	186	216	20.7		
CASA ratio	NA	25.0	NA	NA	28.4	25.6			
Advances book details (Rs bn)									
Advances	105	117	NA	NA	136.2	149	26.9		
Retail	26	30	NA	NA	39.83	43	44.7		
SME	NA	49	NA	NA	NA	61	24.0		
Retail advances to total advances (%)	24.5	25.5	NA	NA	29.2	29.1			
Capital adequacy details (%)									
Capital Adequacy ratio	11.3	13.8	NA	12.8	14.6	13.4			
Tier I	NA	9.7	NA	NA	9.8	9.0			
Asset quality details									
Amount of Gross NPLs (Rs mn)	NA	5,631	NA	5,440	NA	4,508	(19.9)		
Amount of Net NPLs (Rs mn)	NA	1,116	NA	856	NA	651	(41.7)		
Gross NPL ratio (%)	5.2	NA	NA	4.1	3.8	3.0			
Net NPL ratio (%)	1.4	NA	NA	0.7	0.6	0.4			
Yield management details (%)									
Yield on advances	9.9	NA	NA	NA	10.0	10.2			
Cost of deposits	5.5	NA	NA	NA	5.5	5.6			
NIM	3.2	NA	NA	NA	3.3	3.1			

Energy

GSPT.BO, Rs60	
Rating	U
Sector coverage view	Attractive
Target Price (Rs)	53
52W High -Low (Rs)	61 - 27
Market Cap (Rs bn)	32.8

Financials

March y/e	2007E	2008E	2009E
Sales (Rs bn)	3.4	4.8	7.1
Net Profit (Rs bn)	0.9	1.0	2.2
EPS (Rs)	1.6	1.8	4.0
EPS gth	*35.1*	*11.8*	*124.4*
P/E (x)	38.2	34.1	15.2
EV/EBITDA (x)	14.8	11.1	6.9
Div yield (%)	0.4	0.4	0.8

Shareholding, March 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	39.1	-	-
FIIs	20.3	0.1	(0.0)
MFs	3.5	0.1	0.0
UTI	-	-	(0.1)
LIC	-	-	(0.1)

GSPL: Stock price running ahead of fundamentals; Downgraded to U

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- **Valuations starting to look expensive**
- **No comfort at current levels from potential regulatory risks; COS could be a risk to earnings**
- **Returns and pipeline tariffs will be regulated**

We have downgraded GSPL stock to U from OP previously noting the steep increase in its price over the past few weeks and the fact that GSPL stock is trading 13.5% above our 12-month DCF-based target price of Rs53. We continue to like GSPL's fundamentals and its position in the rapidly growing Indian gas market. However, we find GSPL's valuations pricey at 2.3X FY2009E book value and 1.3X FY2009E gross cash invested (GCI); these look intuitively high for a likely regulated business, especially since we have factored the likely growth in asset base through FY2009. We look at EV/GCI in GSPL's case as its book value is pulled down by its aggressive depreciation policy on pipelines. We could pull up our DCF-based valuation by assuming higher tariffs but the financial returns may not be consistent with imminent regulations for the gas transportation business. The regulatory mechanism and allowed returns would influence GSPL's future earnings. We recommend investors book profit at current levels and look at better entry points.

Imminent regulations on gas transportation business would need careful watching. We expect the recently formed Petroleum and Natural Gas Regulatory Board to bring regulations on gas transportation and distribution by end-FY2008/early-FY2009. The petroleum ministry has constituted the board recently although final approvals from the PMO and cabinet on the appointments are pending. We are not sure about the regulatory mechanism to be adopted by the regulator; we note that regulatory framework for the Indian power sector (closest comparable) and global practices in gas transportation are quite different.

The key issues are (1) depreciation treatment, (2) allowed returns and (3) allowed capital structure or debt-equity ratio. As shown in Exhibit 1, GSPL's earnings could vary depending on the nature of regulations. The three key variables are (1) treatment of depreciation or whether the return-earning asset base would reduce over time with depreciation, (2) allowed post-tax equity return and (3) the allowed capital structure or debt-equity ratio; this may not matter if the ratio is fixed at the beginning of a project although it becomes material if regulations come into force a few years after the asset has been in existence. We note that under the globally accepted cost of services (COS) methodology, the return-earning asset base of the regulated entity is reduced every year (unless fresh capex takes place) by the depreciation amount. However, in case of the power sector in India, the return-earning asset base remains the same throughout the life of the plant or the power purchase agreement (PPA).

The nature of regulations will be critical for GSPL's returns and thus, tariffs

Hypothetical example of impact of earnings of various regulatory methodologies and debt-equity ratio

	2009E			2010E		
	Scenario 1	Scenario 2	Scenario 3	Scenario 1	Scenario 2	Scenario 3
1. Computation of regulated earnings based on gross block (no reduction to return-earning asset)						
Gross block at end of period (Rs mn)	32,326	32,326	32,326	32,577	32,577	32,577
Debt (%)	—	50	70	—	50	70
Equity (%)	**100**	**50**	**30**	**100**	**50**	**30**
Asset financed by equity (Rs mn)	32,326	16,163	9,698	32,577	16,289	9,773
Asset financed by debt (Rs mn)	—	16,163	22,628	—	16,289	22,804
Post-tax return on equity (%)	14.0	14.0	14.0	14.0	14.0	14.0
Net profit	**4,526**	**2,263**	**1,358**	**4,561**	**2,280**	**1,368**
Current market capitalization (Rs mn)	32,674	32,674	32,674	32,674	32,674	32,674
Implied P/E on regulated earnings (X)	7.2	14.4	24.1	7.2	14.3	23.9
KIE FY2009E net income (Rs mn)	**2,158**	**2,158**	**2,158**	**3,010**	**3,010**	**3,010**
FY2009E P/E (X)	15.1	15.1	15.1	10.9	10.9	10.9
KIE FY2009E ROAE (%)	16.7	16.7	16.7	19.6	19.6	19.6
KIE FY2009E CROCI (%)	17.8	17.8	17.8	19.4	19.4	19.4
2. Computation of regulated earnings based on net block (Cost of Services methodology)						
Gross block at end of period (Rs mn)	24,486	24,486	24,486	22,043	22,043	22,043
Debt (%)	—	50	70	—	50	70
Equity (%)	**100**	**50**	**30**	**100**	**50**	**30**
Asset financed by equity (Rs mn)	24,486	12,243	7,346	22,043	11,022	6,613
Asset financed by debt (Rs mn)	—	12,243	17,140	—	11,022	15,430
Post-tax return on equity (%)	14.0	14.0	14.0	14.0	14.0	14.0
Net profit	**3,428**	**1,714**	**1,028**	**3,086**	**1,543**	**926**
Current market capitalization (Rs mn)	32,674	32,674	32,674	32,674	32,674	32,674
Implied P/E on regulated earnings (X)	9.5	19.1	31.8	10.6	21.2	35.3
KIE FY2009E net income (Rs mn)	**2,158**	**2,158**	**2,158**	**3,010**	**3,010**	**3,010**
FY2009E P/E (X)	15.1	15.1	15.1	10.9	10.9	10.9
KIE FY2009E ROAE (%)	16.7	16.7	16.7	19.6	19.6	19.6
KIE FY2009E CROCI (%)	17.8	17.8	17.8	19.4	19.4	19.4

Note:

(1) Our projected net debt-to-capitalization ratio for GSPL at end-FY2009E is 43% and at end-FY2010E is 26%.

Source: Kotak Institutional Equities estimates.

Profit model, balance sheet, cash model of GSPL, March fiscal year-ends, 2005-2011E (Rs mn)

	2005	2006	2007E	2008E	2009E	2010E	2011E
Profit model (Rs mn)							
Net sales	2,035	2,635	3,365	4,844	7,121	8,479	8,881
EBITDA	**1,293**	**1,942**	**2,735**	**4,132**	**6,276**	**7,437**	**7,708**
Other income	20	45	163	20	33	29	25
Interest	(363)	(413)	(393)	(922)	(943)	(798)	(474)
Depreciation	(656)	(791)	(1,203)	(2,037)	(2,394)	(2,696)	(2,689)
Pretax profits	293	783	1,302	1,194	2,972	3,972	4,571
Tax	(15)	(2)	(3)	—	(333)	(899)	(1,610)
Deferred taxation	(119)	(315)	(438)	(232)	(480)	(63)	72
Net profits	**160**	**467**	**860**	**962**	**2,158**	**3,010**	**3,032**
Earnings per share (Rs)	**0.6**	**1.2**	**1.6**	**1.8**	**4.0**	**5.5**	**5.6**
Balance sheet (Rs mn)							
Total equity	4,037	9,075	9,797	10,609	12,462	14,857	14,432
Deferred tax liability	193	508	946	1,179	1,659	1,722	1,650
Total borrowings	4,436	5,786	10,202	13,636	11,636	6,136	4,386
Currrent liabilities	571	1,771	1,197	1,121	1,116	1,117	1,118
Total liabilities and equity	**9,237**	**17,140**	**22,142**	**26,545**	**26,873**	**23,832**	**21,586**
Cash	426	2,372	231	452	636	337	508
Current assets	408	995	1,317	1,533	1,628	1,329	1,351
Total fixed assets	8,392	13,651	20,470	24,436	24,486	22,043	19,604
Investments	—	—	—	—	—	—	—
Deferred expenditure	11	123	123	123	123	123	123
Total assets	**9,237**	**17,140**	**22,142**	**26,545**	**26,873**	**23,832**	**21,586**
Free cash flow (Rs mn)							
Operating cash flow, excl. working capital	844	1,562	2,009	3,058	4,805	5,738	5,624
Working capital changes	(193)	471	(897)	(292)	(100)	300	(21)
Capital expenditure	(1,799)	(6,049)	(7,693)	(5,850)	(2,250)	(250)	(250)
Investments	—	—	—	—	—	—	—
Other income	10	40	163	20	33	29	25
Free cash flow	**(1,138)**	**(3,976)**	**(6,418)**	**(3,064)**	**2,489**	**5,817**	**5,378**
Ratios (%)							
Debt/equity	104.9	60.4	95.0	115.7	82.4	37.0	27.3
Net debt/equity	51.2	37.6	48.7	53.6	45.2	27.0	21.4
RoAE	4.6	6.8	8.5	8.5	16.7	19.6	18.6
RoACE	**8.0**	**9.9**	**9.3**	**9.1**	**13.6**	**15.2**	**15.1**
Key assumptions							
Volumes-old pipelines (mcm/d)	8.3	10.4	12.8	15.0	17.0	20.0	25.0
Volumes-new pipelines (mcm/d)	—	—	1.7	4.9	13.1	24.6	30.6
Volumes (mcm/d)	**8.3**	**10.5**	**14.5**	**19.9**	**30.1**	**44.6**	**55.6**

Source: Kotak Institutional Equities estimates.

Our 12-month DCF-based target price for GSPL is Rs53

DCF valuation of GSPL (Rs mn)

	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E
EBITDA	2,735	4,132	6,276	7,437	7,708	8,457	8,326	8,305	8,284	8,261	8,238
Adjusted tax expense	(4)	—	(439)	(1,080)	(1,777)	(2,152)	(2,204)	(2,276)	(2,354)	(2,434)	(2,519)
Change in working capital	(897)	(292)	(100)	300	(21)	(48)	6	—	—	—	—
Operating cash flow	**1,834**	**3,840**	**5,737**	**6,657**	**5,909**	**6,257**	**6,128**	**6,029**	**5,930**	**5,827**	**5,719**
Capital expenditure	(7,693)	(5,850)	(2,250)	(250)	(250)	(250)	(250)	(250)	(250)	(250)	(1,363)
Free cash flow	**(5,859)**	**(2,010)**	**3,487**	**6,407**	**5,659**	**6,007**	**5,878**	**5,779**	**5,680**	**5,577**	**4,356**
Discounted cash flow	**(5,731)**	**(1,755)**	**2,719**	**4,459**	**3,517**	**3,332**	**2,911**	**2,556**	**2,243**	**1,965**	**1,371**
Discounted cash flow-1 year forward		(1,966)	3,045	4,995	3,939	3,733	3,260	2,862	2,512	2,202	1,535
Discounted cash flow-2 year forward			3,411	5,594	4,412	4,181	3,653	3,206	2,813	2,466	1,720

	Now	+ 1-year	+ 2-years
Discount rate (%)	12.0	12.0	12.0
Total PV of free cash flow	17,587	27,341	34,362
Terminal value assumption			
Growth to perpetuity (%)	—	—	—
FCF in 2018E	4,356	4,356	4,356
Exit FCF multiple (X)	8.3	8.3	8.3
Exit EV/EBITDA multiple (X)	4.4	4.4	4.4
Terminal value	36,303	36,303	36,303
PV of terminal value	11,423	11,423	11,423
Total company value	**29,010**	**38,764**	**45,785**
Net debt	3,414	9,971	13,184
Equity value	25,596	28,794	32,601
Shares outstanding (mn)	543	544	545
Estimated share price using DCF	**47.1**	**52.9**	**59.9**

Source: Kotak Institutional Equities estimates.

Chemicals

RELI.BO, Rs1699	
Rating	U
Sector coverage view	Neutral
Target Price (Rs)	1,375
52W High -Low (Rs)	1705 - 806
Market Cap (Rs bn)	2,368

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	1,052	979	1,148
Net Profit (Rs bn)	107.3	101.9	138.9
EPS (Rs)	77.0	73.2	95.6
EPS gth	*22.0*	*(5.0)*	*30.7*
P/E (x)	22.1	23.2	17.8
EV/EBITDA (x)	13.2	14.3	10.5
Div yield (%)	0.6	0.7	0.8

Shareholding, March 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	43.5	-	-
FIIs	23.1	7.4	0.7
MFs	2.5	4.9	(1.9)
UTI	-	-	(6.7)
LIC	4.5	7.9	1.2

Reliance Industries: What to do now? Starting from the first principles and redoing the math may help

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- **Our analysis suggests that the market is ascribing US$28 bn for emerging E&P, retailing, SEZs**
- **We can justify about Rs850-900/share (US$29-31 bn) for extant businesses plus investments**
- **The gap between the stock price and realistic valuation of extant businesses is too large**

The 25% surge in Reliance Industries' stock price and US$14 bn addition to market capitalization over the past 45 days has left us stupefied by the growing gap between Reliance's current valuation based on its stock price and our valuation of its extant businesses (Rs863/share; US$29 bn). We see the gap at about US$28 bn, which seems very large based on our understanding of its new businesses. Our questioning of Reliance's valuations may seem heretical but it may help look at the building blocks of Reliance's current valuation without falling prey to orthodoxy; we find the street's almost dogmatic faith in the stock's performance alarming. We also see no merit in trying to justify the current stock price (as a section of the street may be doing) through (1) higher multiples for earnings of extant businesses (chemicals, refining), (2) aggressive assumptions on E&P or (3) combination of the two. We retain our 12-month fair value of Rs1,375 for Reliance stock. Key upside risk is higher-than-expected margins, new discoveries.

Let's try and freeze the valuation of the extant businesses first; there should be some agreement here. We find it difficult to give a value of more than Rs900/share (or about US$30 bn) for (1) Reliance's extant businesses (chemicals, refining, E&P) and (2) investments (RPL, IPCL, others). Exhibit 1 gives details of our valuation (Rs863) of Reliance's extant businesses. We use 8X P/E multiple on adjusted EPS of Rs68 for FY2008E (Rs73 adjusted up for treasury shares and adjusted down for 19% tax rate in FY2008E) to arrive at Rs544 for Reliance's current earnings-generating businesses. We use 8X P/E multiple based on 12.5% cost of equity; our multiple may be a bit on the higher side given that FY2008E chemical and refining margins would be well above mid-cycle or normalized levels. We would caution against using higher multiples for extant earnings based on growth in earnings coming from new businesses (new refinery in RPL, E&P). We have seen this oversight among investors and sell-side analysts alike. We add Rs320 for value of Reliance's investments (but exclude Reliance's investment in Reliance Retail) in this analysis; the bulk of the value comes from Reliance's 75% ownership in Reliance Petroleum; we use our 12-month fair value of Rs100 instead of the moderately lower current market price of Rs92.

Let's try and see what the market is implying for the new initiatives. Our Rs863 fair valuation of Reliance's extant businesses plus investments would imply a value of Rs837/share (US$28 bn) for Reliance's new initiatives—emerging E&P, retailing and SEZs. This simply seems very large to us in the context of the (1) information available (both official and guesswork on reserves) for the emerging E&P business and (2) early stage of the new initiatives (retailing, SEZs).

Retailing. We ascribe a US$3.75 bn valuation for Reliance's retailing business in the exercise shown in Exhibit 1and our official valuation model given in Exhibit 2. We note that Reliance has invested about US$1 bn in its retailing business. Exhibit 3 gives our valuation approach for Reliance's retailing business.

SEZs. We do not ascribe any valuation to the SEZs currently given the early stage of land acquisition and development. We note that Reliance Industries has ownership of only two SEZs (Haryana, Jamnagar) out of the four being developed by Reliance Industries group; the group's two proposed SEZs near Mumbai are not in the listed entity.

Emerging E&P. Based on our analysis in Exhibit 1, we would conclude that the market is ascribing about US$25 bn for Reliance's emerging E&P business. This looks very high to us even if we start ascribing valuation for Reliance's potentially higher reserves in D6 (KG-DWN-98/3) and potential large hydrocarbon discoveries in D4 (MN-DWN-2003/1) blocks. The earliest confirmation on D4 reserves (if any) will be available around December 2008 when Reliance will start drilling in the block.

We find the market's penchant to give valuations for any discoveries and speculation disturbing. We do not deny that new discoveries will be a positive for Reliance's valuations; that's obvious to us also. However, we find it worrying that the market is not willing to look at any potential downside from (1) dispute with RNRL on supply of gas, (2) price of natural gas in the context of large coal reserves in India, (3) limited progress on new power and fertilizer plants, which can absorb Reliance's 80 mcm/d of gas production from KG D-6 block let alone new discoveries. We have discussed supply, demand and pricing issues in more detail in our April 23 note. Exhibit 4 shows that Reliance may not be in a position to place its targeted 80 mcm/d of gas immediately unless sufficient numbers of power and fertilizer plants commence construction shortly. However, the ongoing dispute with RNRL (until resolved) may prevent Reliance from signing firm supply agreements with potential power and fertilizer plants. At the same time, the concerned power and fertilizer units may not achieve financial closure without firm supply agreements (for a sufficiently long period, not short or medium-term contracts, which Reliance is apparently keen on as per press reports).

If the D4 block has similar or higher reserves compared to Reliance's D6 block (as is commonly believed now and already factored in the stock price, in our view), we doubt the Indian market may be in a position to absorb so much gas. Reliance may have to phase production of gas, which have an impact on valuation (time value of money) or look at exports (if the government allows). However, the latter may have serious implications for global gas pricing as India is conventionally considered a gas 'sink' as compared to a gas exporter; the early part of the next decade will see a big ramp up in gas supply from several large projects (Iran, Sakhalin, Gorgon and other projects in North West Australia,). A number of such projects are banking on the Indian market to absorb the gas.

A bridge too far for us

Estimation of implied valuation of new businesses of Reliance Industries (US$ bn)

		Comments
1. Valuation of extant businesses		**Chemicals, RIL refinery, extant oil and gas**
FY2008E EPS of Reliance (Rs)	73.2	Moderately lower than FY2007 EPS due to weaker chemical margins, stronger rupee
FY2008E EPS adjusted for treasury shares (Rs)	83.4	Adjusted for 170 mn treasury shares
Effective tax rate in FY2008E (%)	19.0	
FY2008E EPS adjusted for tax rate	67.9	Normalized for 34% tax rate for extant earnings
Appropriate P/E multiple (X)	8.0	Generous given above mid-cycle margins, earnings and cost of equity of 12.5%
Valuation of extant businesses (Rs)	**544**	
Valuation of extant businesses	**18.5**	**Reasonable in the context of replacement value, returns**
2. Valuation of investments		**RPL, IPCL, others (without Reliance Retail)**
Reliance Petroleum	276	3.375 bn shares at Rs100, our 12-month target price for RPL
IPCL, others	44	
Total value of investments	**320**	
Valuation of RIL ex-new E&P, retailing, SEZs	**863**	
Current stock price	1,698	
3. Valuation of new businesses		**Emerging E&P business, retailing, SEZs**
Market-ascribed value of new businesses	**835**	
Market-ascribed value of new businesses (US$ bn)	**28**	
Estimated valuation of retailing (US$ bn)	3.8	Reliance has invested about US$1 bn in Reliance Retail as at end-FY2007
Estimated valuation of SEZs (US$ bn)	—	Value will take time to emerge
Market-ascribed value of emerging E&P business	**25**	**Seems very high to us based on official reserves, announed discoveries**
Estimated value of Reliance's stake in KG D-6 (gas)	5.0	Based on gas production of 17 tcf, US$8.8 bn capex, US$4/mn BTU net price
Estimated value of Reliance's stake in KG D-6 (oil)	0.9	0.5 bn bbls of OOIP assumed versus current announced reserves of 180 mn bbls
Estimated value of Reliance's stakes in NEC-25, CBM	1.4	
Implied value of new discoveries	**17**	**Higher reserves in KG D-6, D-4, Gujarat/Saurashtra blocks?**

Source: Kotak Institutional Equities estimates.

12-month fair valuation is Rs1,375

Valuation of Reliance stock on SOTP (Rs)

	FY2010E EPS (Rs)	P/E (X)	Valuation (Rs/share)	Comments
Chemicals, refining, E&P (a) (b)	169	9	1,521	Consolidated FY2010E EPS including Reliance Petroleum
E&P (higher reserves in KG-DWN-98/3)			—	We model 17 tcf of gas production rom KG-DWN-98/3 block
E&P (NEC-25, CBM)			44	Based on KG D-6 reserves and valuation
Investments			147	
IPCL and other investments			35	
Retailing			112	US$3.75 bn valuation; ~US$1 bn equity invested in Reliance Retail as of end-FY2007
SEZ development			—	SEZs will require investment for the first few years
Valuation using FY2010E EPS			**1,713**	
12-month forward valuation			**1,367**	**12.5% discount rate; discounted to April 2008**

Notes:

(a) FY2010E EPS is Rs150 on 1.513 bn shares without considering merger of IPCL but conversion of 120 mn warrants.

(b) FY2010E EPS is adjusted for treasury shares or computed using 1.343 bn shares.

(c) Number of shares outstanding after merger of IPCL will be 1.57 bn including 199 mn treasury shares.

Source: Kotak Institutional Equities estimates.

Reliance can create meaningful value in retailing if it executes well; value will depend on speed of execution and land price/rental

Rough model of Reliance's retailing initiative (Rs bn)

		Comments
Total investment	250	
Land purchase cost	150	50% of stores land leased @ 4% of revenues, 50% of stores land purchased @ Rs3,750/sq ft
Other assets capex including back-end	100	
Return on capital employed (%)	**15.0**	**Pantaloon's ROCE will be about 14-15% over the next few years**
EBIT * (1-t)	38	
Tax rate (t, %)	34	
EBIT	57	
Depreciation (@4% of assets excluding land)	4	Depreciation for building and fixtures
EBITDA	61	
EBITDA margin (%)	**9.5**	**Normal EBITDA margin 7.5%; lease cost = 4% of revenues, 2% for 50% of stores**
Sales	640	
Sales (US$ bn)	**16**	**Total organized retail sales is about US$7 bn currently; unorganized is US$230 bn**
Sales/sq ft (Rs/sq ft)	8,000	
Retailing area (mn sq ft)	**80**	**Current organized retail space in India is about 40 mn sq ft; Pantaloon has 3.8 mn sq ft**
Debt	150	
Equity	100	
Interest (@ 8%)	12	
Profit before tax	45	
Profit after tax	30	
P/E multiple (X)	15	
Equity value of retailing	444	
# of years to reach above targets	**7**	
Cost of equity (%)	12.5	
Current equity value	**151**	
Current value/share (Rs/share)	**112**	

Value per share based on various P/E multiples and years required to reach target sales

P/E multiple (X)	Years to reach target investment and sales (#): 6	7	8	9	10
12	**94**	**83**	**74**	**66**	**58**
13	**105**	**93**	**83**	**73**	**65**
14	**115**	**103**	**91**	**81**	**72**
15	**126**	**112**	**100**	**89**	**79**
16	**137**	**122**	**108**	**96**	**86**
17	**148**	**132**	**117**	**104**	**92**
18	**159**	**141**	**125**	**112**	**99**

Source: Kotak Institutional Equities estimates.

New power plants of NTPC, REL, others critical for gas consumption; internal 'sales' insufficient given large supply

Supply and potential sales of gas from KG D-6 block (mcm/d)

		Comments
Reliance KG D-6 gas peak production	**80**	**This could increase to 120 mcm/d**
1. Firm demand		
Consumption in RIL and RPL refineries	12	
Shortfall in KG basin area + new power generation capacity	8	Shortage of about 3 mcm/d; planned new capacity of 1,878 MW
Sub-total	**20**	
2. Potential demand in short/medium-term		
Conversion of FO/naphtha urea units to gas	11	Most units can switch to gas quickly as pipeline infrastructure exists
Replacement of FO/LSHS from industrial units	25	This will likely take time given wide disperson of consumption
Sub-total	**36**	
3. Possible (medium-term)		
NTPC gas supply	10	Construction of 2 X 1,300 MW power plants not commenced
RNRL/REL gas supply	11	Construction of 2,720 MW power plant not commenced
City gas distribution	5	Submitted plans to various state governments; will take time
Sub-total	**26**	
Total	**82**	

Source: Kotak Institutional Equities estimates.

Banking

HDBK.BO, Rs1072	
Rating	IL
Sector coverage view	Neutral
Target Price (Rs)	1,180
52W High -Low (Rs)	1150 - 620
Market Cap (Rs bn)	342.4

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	52.9	65.4	83.4
Net Profit (Rs bn)	11.4	15.0	19.4
EPS (Rs)	35.7	47.0	60.7
EPS gth	*28.5*	*31.6*	*29.0*
P/E (x)	30.0	22.8	17.7
P/B (x)	5.5	4.7	3.9
Div yield (%)	0.7	0.9	1.1

Shareholding, March 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	21.6	-	-
FIIs	51.3	2.6	1.5
MFs	3.1	1.0	(0.1)
UTI	-	-	(1.1)
LIC	3.0	0.8	(0.2)

HDFC Bank: Plans US$1bn equity issuance, parent company (HDFC) to maintain stake

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- **HDFC Bank is planning to raise around US$1bn from the equity markets to fund its growth**
- **HDFC Ltd, the parent company, to maintain current stake in the company**
- **Recommend the stock as a core holding**

HDFC Bank is planning to raise around US$1bn from the equity markets to fund its growth. This is around 12-13% of HDFC Bank's current market capitalization and 66% of its FY2007 networth. HDFC Ltd, the parent company will be subscribing to 13.58mn shares at Rs1,023 in a preferential allotment to maintain its current stake in the bank at around 21.5%. In our estimate HDFC Bank's RoE will likely come off in the immediate term till the company increases leverage but still remain high at around 17-18%. The bank's PBR will fall to 3.2X FY2008 and 2.8X FY2009, from 4.7X and 3.9X respectively. We estimate HDFC Bank's Tier I to increase to around 12% (based on FY2007 risk weight assets). We retain our stock price target of Rs1,180 per share and believe that the company should form a part of investor's core holding.

Energy

CAIR.BO, Rs144	
Rating	U
Sector coverage view	Attractive
Target Price (Rs)	130
52W High -Low (Rs)	160 - 111
Market Cap (Rs bn)	254.7

Financials

December y/e	2006	2007E	2008E
Sales (Rs bn)	18.3	19.0	21.3
Net Profit (Rs bn)	1.1	0.7	1.1
EPS (Rs)	0.6	0.4	0.6
EPS gth	*(68.1)*	*(40.1)*	*61.7*
P/E (x)	236.6	387.3	242.2
EV/EBITDA (x)	42.6	40.7	34.1
Div yield (%)	-	-	-

Cairn India: Speculation on bids for Cairn Plc; risk-reward balance is not very favorable to jump in

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- **Current stock price is discounting US$53/bbl crude price in perpetuity and no regulatory, execution risks**
- **US$53/bbl for Cairn's crude would imply at least US$60/bbl in perpetuity for WTI, Brent**
- **5-10% upside exists if takeover bid emerges; downside is higher, in case of no takeover bids**

Cairn India stock price has rallied over the past few days driven by speculation of possible takeover bids for its parent company Cairn Energy Plc. Unconfirmed reports in British newspapers have cited Malaysia's Petronas and Swiss refiner Petroplus as interested parties; we note that Petronas owns 10% stake in Cairn India, Cairn's Plc main asset, which it acquired in a pre-IPO placement at Rs160/share. The pre-IPO placement price may be a good indicator of the potential acquisition price if press reports turn out to be true. We doubt that a potential acquirer would be keen to pay a substantial premium to fair value in light of significant uncertainty surrounding (1) pricing of Cairn's Rajasthan crude oil, (2) delivery and consumption of crude oil, (3) pipeline status and (4) royalty/cess. On the other hand, we see potential large downside given our current fair value Cairn stock is Rs118 only (12-month DCF-based target price is Rs130) if the market speculation turns out to be false.

Stock is discounting a lot of positives; advice caution. Our current fair value of Cairn stock is Rs118 only (see Exhibit 1) based on (1) US$50/bbl normalized Dated Brent price from 2011E, (2) US$3.9/bbl discount to Dated Brent price for price of Rajasthan crude, (3) full opex and capex recovery of pipeline to deliver crude to refineries, IOC's Viramgram terminal or to a port on West Coast and (4) nil royalty and cess.

Significant risks to our fair value exist. Exhibit 2 shows that the valuation of Cairn's Rajasthan asset (Cairn India's main asset; also of Cairn Energy Plc) is highly dependent on (1) the assumed price of crude and (2) quantum of royalty and cess, if any. We note that our base case assumes US$60/bbl Dated Brent price from 2011 and US$3.9/bbl discount for Cairn's Rajasthan crude. However, we do not rule out a larger discount (higher Dated Brent price in other words for the same net price to Cairn) given the heavy, waxy nature of Cairn's crude (API is 27° although sulfur content is low), which may preclude consumption by several Indian refineries. As of now, MRPL has indicated its desire to lift 1-1.2 mtpa of crude oil out of the likely 7.5 mtpa plateau production. Private sector refineries may demand a larger discount, in our view.

Also, the cess is still to be addressed in favor of Cairn. Our model assumes that Cairn will not pay any royalty or cess on the portion of crude oil (70%) produced by it. However, imposition of cess (Rs927/tonne or Rs2,575/tonne) may be a large negative for Cairn's earnings and valuation. More important, we are not sure if a potential bidder would want to pay a large premium to Cairn's fair value without resolution or clarity on this vital issue.

What does a bid for Cairn Energy Plc mean for a Cairn India shareholder? A change in management control of Cairn Energy Plc (if and when it takes place) would result in the new owner having to make an open-offer for 20% of Cairn India's shares as per Indian takeover guidelines. This would push the new owner's ownership dangerously close to 90%, which may make the new owner think about a potential de-listing of Cairn India stock. However, de-listing has turned out be a very frustrating experience in general for acquiring companies. Indian shareholders have stubbornly refused to hand over their shares to the acquiring company and have waited for a better offer. Cairn India shareholders could similarly hold out for a higher price. An acquirer of Cairn Energy Plc would need to factor this potentially difficult situation in its acquisition plan.

If the new owner of Cairn Energy Plc chooses to retain the listed status of Cairn India, the blended price for a Cairn India shareholder would be the weighted average price of 20 shares sold at open-offer price (say Rs160) and 10.5 shares retained at the post open-offer market price (say Rs130). In this hypothetical scenario, the weighted average price for a current Cairn India shareholder would be Rs150.

We value Cain India stock at Rs130

EV and equity value of Cairn (US$ mn)

	Now	+ 1-year	+ 2-years
RJ-ON-90/1	3,631	4,265	5,153
CB-OS-2	161	114	74
Ravva	340	303	264
Upside potential (KG-DWN-98/2, RJ-ON-90/1)	563	625	694
Total	**4,695**	**5,307**	**6,185**
Net debt	(157)	39	487
Equity value	**4,852**	**5,267**	**5,698**
Equity shares (mn)	1,765	1,765	1,765
Equity value per share (Rs/share)	**118**	**128**	**139**

Source: Kotak Institutional Equities estimates.

Cairn's Rajasthan field's enterprise value is highly leveraged to crude prices, regulations

Enterprise value sensitivity of Cairn to key variables (US$ bn)

	Sensitvity of current valuation		Sensitvity of +1-year valuation	
	Enterprise value (US$ bn)	Change from base case (%)	Enterprise value (US$ bn)	Change from base case (%)
Average crude prices (2011 and beyond)				
Dated Brent price (US70$/bbl)	4.9	36	5.7	34
Dated Brent price (US60$/bbl)	4.3	20	5.1	19
Dated Brent price (US55$/bbl)	4.0	10	4.7	9
Dated Brent price (US50$/bbl)	**3.6**		**4.3**	
Dated Brent price (US40$/bbl)	2.9	(20)	3.5	(18)
Dated Brent price (US30$/bbl)	2.3	(36)	2.8	(34)
Cess, royalty				
Royalty (Rs0/tonne), Cess (Rs0/tonne)	**3.6**		**4.3**	
Royalty (Rs0/tonne), Cess (Rs927/tonne)	3.3	(8)	3.9	(8)
Royalty (Rs0/tonne), Cess (Rs2,575/tonne)	2.9	(19)	3.5	(18)
Royalty (Rs481/tonne), Cess (Rs927/tonne)	2.4	(34)	2.9	(32)
Royalty (Rs481/tonne), Cess (Rs2,575/tonne)	1.9	(48)	2.3	(45)

Source: Kotak Institutional Equities estimates.

Profit model, balance sheet, cash model of Cairn 2006-2013E, calendar year-ends (Rs mn)

	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E
Profit model (Rs mn)								
Net sales	18,306	19,048	21,262	44,056	101,112	84,436	81,760	79,651
EBITDA	**5,288**	**5,767**	**8,008**	**29,985**	**76,435**	**52,180**	**38,118**	**31,037**
Other income	524	531	85	105	138	388	791	1,119
Interest	(404)	(62)	(69)	(500)	(406)	—	—	—
Depreciation	(3,935)	(5,477)	(6,265)	(7,727)	(9,517)	(9,146)	(9,228)	(9,348)
Pretax profits	1,474	759	1,759	21,863	66,649	43,422	29,682	22,808
Tax	(372)	(24)	(607)	(3,755)	(8,426)	(5,625)	(4,159)	(3,402)
Deferred taxation	(25)	(77)	(100)	(1,001)	(1,074)	(524)	(92)	244
Net profits	**1,077**	**658**	**1,052**	**17,107**	**57,149**	**37,273**	**25,431**	**19,650**
Earnings per share (Rs)	**0.6**	**0.4**	**0.6**	**9.7**	**32.4**	**21.1**	**14.4**	**11.1**
Balance sheet (Rs mn)								
Total equity	283,527	284,185	285,237	302,344	318,185	322,412	325,296	327,525
Deferred tax liability	3,205	3,283	3,383	4,384	5,458	5,982	6,074	5,831
Total borrowings	21,245	3,745	23,745	16,245	—	—	—	—
Currrent liabilities	1,742	1,791	1,787	1,924	3,536	4,688	6,411	7,168
Total liabilities and equity	**309,720**	**293,004**	**314,152**	**324,898**	**327,180**	**333,083**	**337,782**	**340,524**
Cash	28,366	2,049	2,806	3,188	4,711	17,504	27,832	36,268
Current assets	1,755	1,827	2,039	4,225	9,696	8,097	7,840	7,638
Total fixed assets	25,301	36,534	60,202	32,140	23,072	20,634	18,092	15,446
Net producing properties	7,698	5,995	2,505	38,746	43,102	40,249	37,419	34,573
Investments	4	4	4	4	4	4	4	4
Goodwill	246,595	246,595	246,595	246,595	246,595	246,595	246,595	246,595
Deferred expenditure	—	—	—	—	—	—	—	—
Total assets	**309,720**	**293,004**	**314,152**	**324,898**	**327,180**	**333,083**	**337,782**	**340,524**
Free cash flow (Rs mn)								
Operating cash flow, excl. working capital	3,109	3,069	4,464	23,081	65,452	45,106	32,509	26,186
Working capital changes	998	(22)	(216)	(2,049)	(3,859)	2,751	1,980	959
Capital expenditure	(14,946)	(12,395)	(23,575)	(13,255)	(2,656)	(2,406)	(2,406)	(2,406)
Investments/Goodwill	(249,804)	—	—	—	—	—	—	—
Other income	524	531	85	105	138	388	791	1,119
Free cash flow	**(260,120)**	**(8,818)**	**(19,242)**	**7,882**	**59,076**	**45,839**	**32,875**	**25,858**
Key assumptions								
Gross production ('000 boe/d)	91.0	89.4	89.4	118.5	204.8	201.9	192.7	184.6
Net production ('000 boe/d)	25.1	25.7	28.8	53.2	117.0	117.8	113.8	110.6
Dated Brent (US$/bbl)	65.3	65.0	60.0	60.0	60.0	50.0	50.0	50.0
Discount of Rajasthan crude to Dated Brent (US$/bbl)	2.1	3.9	3.9	3.9	3.9	3.9	3.9	3.9

Source: Kotak Institutional Equities estimates.

Strategy

Sector coverage view	N/A

Alpha Bet: Booking profits on Buy SBI, sell UTI Bank, CBoP trade

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- **Trade: Buy SBI, sell UTI Bank, CBoP—book profits on 8%+ benchmark returns**
- **Trade # 1: Buy Infosys, sell TCS—continue to play valuation opportunity**
- **Trade # 2: Buy ABNL, sell Idea Cellular—Idea valued in ABNL at less than CMP**

We have booked profits in our buy SBI, sell a basket of UTI Bank and CBoP trade. While strategically positive on PSU banks, we believe that most of the immediate positive triggers are already in the jump in the SBI's price: value unlocking of non-bank investments, changes in Subsidiary Act, inflation top off. We persist with our other two trades. First, we advise investors to buy Infosys and sell TCS. This plays a likely return to the valuation premium that Infosys has typically enjoyed over TCS, given our view that Infosys (FY08E P/E of 23.1) has recently underperformed TCS (FY08E P/E of 23.7) despite little change in operating metrics. Given a likely impending ADR issue announcement by TCS, we would time the short leg of the trade near the event. Second, we would buy ABNL and sell Idea in order to play a likely trigger in insurance and deep discount value for its stake in Idea. Our telecom team believes that Idea's valuations are stretched and ABNL is thus a better way to play the telecom story in Idea. We highlight that ABNL's current market price implies a value of Idea's share at Rs103 which is far below the market price. This will likely cushion the impact of a correction in Idea's price on ABNL price.

Book profits on SBI vs UTI Bank, CBoP trade

Alpha Bet trade statistics (prices in INR)

Trade action	Stock	Initiation price	Fundamental Target price	CMP	Returns
Trade 1					
Buy	Infosys	2,000	2,500	1,982	-0.9
Sell	TCS	1,253	1,400	1,252	-0.1
Trade 2 - Book profits					
Buy	SBI	1,149	1,400	1,326	15.4
Sell	UTI Bank	520	410	537	3.3
	CBoP	40	35	41	2.5
Trade 3					
Buy	ABNL	1,164	1,350	1,268	8.9
Sell	Idea Cellular	114	100	116	1.8

Source: Bloomberg, Kotak Institutional Equities estimates.

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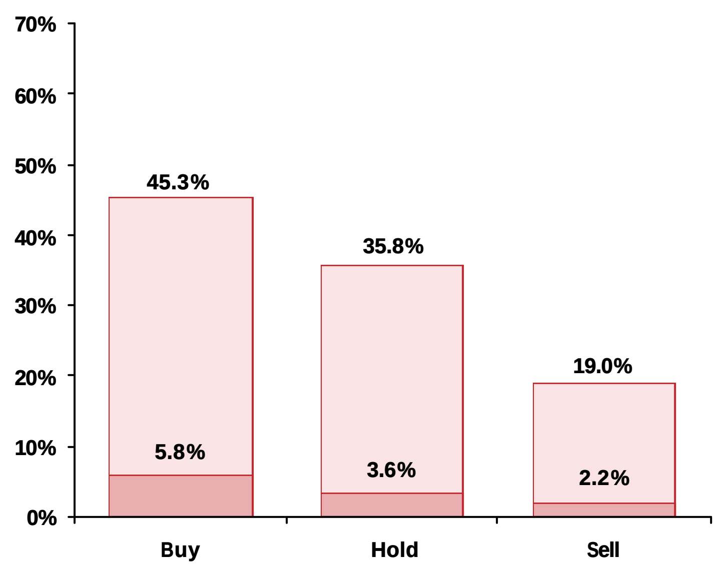

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Source: Kotak Institutional Equities. As of March 31, 2007

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