INDIA DAILY

November 05, 2007

EQUITY MARKETS

	Change, %			
India	**2-Nov**	**1-day**	**1-mo**	**3-mo**
Sensex	19,976	1.3	12.4	32.0
Nifty	5,932	1.1	14.4	34.8
Global/Regional indices				
Dow Jones	13,595	0.2	(3.3)	3.1
Nasdaq Composite	2,810	0.6	1.1	11.9
FTSE	6,531	(0.8)	(1.0)	4.9
Nikkie	16,363	(0.9)	(4.1)	(3.6)
Hang Seng	29,896	(1.9)	7.4	32.6
KOSPI	2,019	(2.1)	1.2	7.6

Value traded - India

	Moving avg, Rs bn			
	2-Nov		**1-mo**	**3-mo**
Cash (NSE+BSE)	279.2		296.4	216.0
Derivatives (NSE)	738.4		614.5	387.8
Deri. open interest	751.9		785.6	796.2

Forex/money market

	Change, basis points			
	2-Nov	**1-day**	**1-mo**	**3-mo**
Rs/US$	39.4	#######	(1)	(94)
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	7.9	1	(3)	1

Net investment (US$mn)

	1-Nov		**MTD**	**CYTD**
FIIs	45		-	17,286
MFs	(91)		-	173

Top movers -3mo basis

	Change, %			
Best performers	**2-Nov**	**1-day**	**1-mo**	**3-mo**
Reliance Energy	1,852	4.8	28.0	145.9
MRF	7,867	(2.0)	111.8	99.3
Neyveli Lignite	141	1.9	29.6	88.6
Engineers India	904	10.0	53.1	90.1
Tata Power	1,297	5.5	37.4	86.5
Worst performers				
i-Flex	1,529	(1.2)	(19.3)	(29.1)
Punjab Tractors	200	(1.2)	(14.0)	(24.3)
Ingersoll Rand	294	(2.2)	(5.0)	(18.6)
Essel Propack	53	(0.4)	(10.2)	(16.8)
Thomas Cook	58	(0.7)	(6.5)	(9.4)

Contents

News Roundup

Corporate

- Hindustan Unilever Ltd (HUL) has put Modern Foods on sale and has received “acceptable” offers from three foreign strategic players. The deal is expected to close in a month’s time. (ET)
- GTL Infrastructure plans to invest US$1.7 bn for setting up 25,00 shared telecom towers across the country. The company has recently raised US$300 mn from FCCB issue and a similar amount from rights and warrants issue. (BS)

Economic and political

- Department of telecommunications (DoT) is said to be preparinf a note to assess the amount of extra spectrum held by telcos and may also impose a time frame by which service providers should either increase their subscriber base or return the excess spectrum. (ET)
- Government is considering oil price hike and cut in excise duty rates in order to manage the spurt in global oil prices (ET)
- RBI has threatened to extend the Usurious Loans Act (ULA) to banks if it continues to receive customer complaints about unreasonably high interest rates (BS)
- Government is expected to amend the Insurance Act to allow world’s largest re-insurer Lloyd’s to enter India (FE)

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

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Economy

India story to continue

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- **Real activity likely to stay buoyant**
- **Corporate performance to stay good; investment cycle to persist**
- **Interest rate to soften a bit; rupee to see sustained appreciation**
- **Key risks: Volatile capital flows, oil prices and government spending**

The Indian economy is poised to record a growth of above 8.5% in FY2008E and FY2009E in spite of concerns on excessive capital flows, exchange rate appreciation and weakened political resolve for further reforms. We expect the investment cycle to persist for at least another two years. Interest rates could soften a bit, while rupee may continue to appreciate.

Real activity likely to stay buoyant

We project real GDP to grow at 8.7% in FY2008E and 8.6% in FY2009E, led by services sector growth of about 10.5%. Industrial growth will likely moderate to 7.5% in FY2009E from 8.0% in FY2008E. We expect agriculture to grow at a modest pace of about 3.3% in FY2008E. We see a positive output gap of about 1.0% over the forecast period; we estimate potential growth is currently at nearly 8.0%.

Corporate performance to stay good; investment cycle to persist

We expect corporates to deliver reasonably strong sales and profits for the next few quarters, which will enable them to pursue their investment plans. The investment cycle could persist at least until FY2009E and corporate fixed investments in major projects could easily top Rs2 tn (US$50 bn) in FY2008E.

Interest rate to soften a bit; rupee to see sustained appreciation

Slower industrial growth expected from November 2007 along with widening interest rate differential could force the central bank to cut its policy rate in early CY2008. We expect headline inflation to remain in the 4.0-4.5% range at the end of FY2008E and rise in 2HFY09. We expect exchange rate to hold for sometime due to expected restrictions on FDI for real estate, but sustained appreciation of about 5% is likely in FY2009E.

Key risks: Volatile capital flows, oil prices and government spending

Volatile capital flows, oil prices and large government spending are key risks to growth and inflation. We expect the trade deficit to climb to 8.3% of GDP in FY2008E and CAD/ GDP ratio to widen to 2.0% of GDP. These gaps are projected to widen further in FY2009E. Nonethless, the BoP is expected to remain manageable. Government spending arising out of (1) election spending and (2) wage hikes following the Sixth Pay Commission report could be positive for growth and equities over the medium-term but at the cost of fiscal consolidation.

Cairn India, Oil & Natural Gas Corporation: Oil nearing US$100/bbl is not so good news for anybody, even for the producers

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- **Significant risks to earnings of downstream R&M oil companies**
- **ONGC has very modest leverage to crude price given subsidy sharing**
- **Cairn's production is too far out, there are PSC limitations and stock price is discounting >US$90/bbl crude price in perpetuity**
- **A retail price increase, higher amount of oil bonds will partly alleviate the problem**

We see the recent surge in crude oil prices as increasing risks to earnings of all the government-owned oil and gas companies, not just of the downstream R&M companies. The earnings of the downstream R&M companies are obviously under the most threat but the current crisis may force the government to increase the share of under-recoveries of the upstream companies. We hope that the government will use the 'right' methods (retail price increase, higher oil bonds) to address the surge in global crude oil prices and not implement retrograde measures like increased burden for the upstream oil companies as it had done in FY2007. We maintain our REDUCE rating on ONGC with a 9X normalized FCF 12-month target price of Rs1,100 and our SELL rating on Cairn India with a DCF-based 12-month target price of Rs145. Key upside risk stems from continued high liquidity in the Indian market.

Gross under-recovery for the industry to jump up sharply in 2HFY08 without a retail price increase. As highlighted in our 2QFY08 result review notes, we expect 2HFY08 gross under-recoveries to be significantly ahead of the 1HFY08 amount of Rs262 bn. Exhibit 1 gives our computation of gross under-recovery for FY2008E. We note that our computation is based on crude price (Dated Brent) estimate of US$82.8/bbl for the balance period of the year. Thus, there may be upside risks to our estimates if crude prices were to persist at current levels or even increase.

Exhibit 2 gives our calculations for under-recoveries broken down by various government-owned companies. As can be seen, the net under-recovery for the downstream R&M companies would increase significantly in FY2008E compared to FY2007 unless the government (1) raises retail selling prices of auto fuels, (2) increases the amount of oil bonds, and (3) increases the share of upstream companies of total under-recoveries. We note that the amount of oil bonds as decided currently for FY2008E is only Rs235 bn, similar to Rs241 bn in FY2007; on the other hand, crude prices in FY2008E will likely be far ahead of the US$65/bbl (Dated Brent) price in FY2007. A higher rupee-dollar rate will only partly offset the likely steep yoy increase in global crude oil prices.

Higher crude price is not good news for anybody really

The impact on the R&M companies is obvious and needs no elaboration. However, the impact on the upstream companies is not as straightforward as the stock prices seem to be implying. We note that the stock prices of ONGC and Cairn have increased steeply over the past one month perhaps led by steep increase in crude oil prices and consequent large positive impact on earnings. We discuss the implications of higher crude prices below for companies other than the downstream oil companies below.

Energy

CAIR.BO, Rs224	
Rating	SELL
Sector coverage view	Neutral
Target Price (Rs)	145
52W High -Low (Rs)	230 - 111
Market Cap (Rs bn)	394.7

Financials

December y/e	2006	2007E	2008E
Sales (Rs bn)	18.3	19.4	21.6
Net Profit (Rs bn)	4.1	2.7	2.8
EPS (Rs)	2.3	0.5	1.6
EPS gth	*28.4*	*(80.4)*	*216.6*
P/E (x)	97.2	442.2	142.5
EV/EBITDA (x)	53.0	46.4	42.5
Div yield (%)	-	-	-

Shareholding, June 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	69.0	-	-
FIIs	11.1	0.4	0.4
MFs	0.6	0.1	0.1
UTI	-	-	-
LIC	2.2	0.4	0.4

Energy

ONGC.BO, Rs1366	
Rating	REDUCE
Sector coverage view	Neutral
Target Price (Rs)	1,100
52W High -Low (Rs)	1387 - 750
Market Cap (Rs bn)	2,922

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	948	1,016	1,042
Net Profit (Rs bn)	173.1	219.2	232.6
EPS (Rs)	80.9	102.5	108.8
EPS gth	*10.2*	*26.6*	*6.1*
P/E (x)	16.9	13.3	12.6
EV/EBITDA (x)	7.2	6.0	5.5
Div yield (%)	2.3	2.4	2.4

Shareholding, June 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	74.1	-	-
FIIs	8.7	2.4	(3.7)
MFs	1.1	1.9	(4.3)
UTI	-	-	(6.1)
LIC	2.2	3.3	(2.8)

ONGC—very modest leverage to higher crude prices at best, with downside risk from change in subsidy-sharing formula. We note that ONGC has very modest leverage to higher crude prices under the extant subsidy-sharing formula with its share of subsidy burden practically nullifying the impact of higher crude prices, both measured in crude oil equivalent terms. ONGC sold 24.4 mn tons of crude oil (standalone basis) in FY2007, which adjusted for blended royalty of about 12.5% (10% for offshore crude, 20% for onshore crude) would work out to about 21 mn tons of net production. Against this, ONGC's subsidy share of the total consumption of the four controlled products in crude equivalent terms works out to about 20 mn tonnes (72 mn tonnes of consumption of four controlled products in FY2007 X 33.33% share for upstream companies X 83% share of ONGC of upstream companies).

Nonetheless, ONGC's consolidated earnings would benefit from higher crude prices with crude produced by OVL (5.8 mn tons in FY2007) benefiting from higher crude prices. This partly explains our higher consolidated EPS estimate for FY2008E at Rs108.5 versus FY2007 EPS of Rs82.4. The other reason is that we model the upstream companies' share of subsidy loss at 33.33% in FY2008E versus 41.5% in FY2007. Exhibit 3 gives our sensitivity computations of ONGC's earnings to various variables but we note that the sensitivity to crude oil prices is mostly theoretical as it does not consider the subsidy impact.

We model FY2008E subsidy at Rs160 bn (Rs170 bn in FY2007), based on ONGC's 1HFY08 subsidy amount of Rs74.5 bn. However, we do not rule out the government raising the subsidy amount for upstream companies in 2HFY08 as it did in FY2007 to counteract the increased subsidy burden on the downstream oil companies. ONGC's net income would reduce to Rs212 bn (Rs99.4 EPS) for FY2008E if the share of upstream companies was to increase to 40% from our assumed 33.33%.

Cairn—real production is about two years away and PSC conditions meaningfully limit the upside from higher crude prices. Our reverse DCF-valuation of Cairn reveals that Cairn's stock price is factoring in US$93/bbl Dated Brent Crude price starting CY2009E (first year of production from its main Rajasthan fields) in perpetuity. If we use our actual crude price forecast of US$70/bbl for 2008E-2012E, then the stock price is factoring in US$120/bbl starting CY2013E in perpetuity. Exhibit 4 shows that our valuation for Cairn does not vary significantly with crude oil prices. At US$50/bbl in perpetuity from CY2013E and US$70/bbl in CY2009-12E, our fair value for Cairn stock comes to Rs142. However, it rises to only Rs165/bbl even if we change our normalized crude price (beyond CY2013E) to US$70/bbl.

We clarify that the moderate leverage to crude price is due to the nature of the PSC under which Cairn will operate its Rajasthan block; higher crude prices will increase Cairn's investment multiple (IM) faster and move the share of the government of profit petroleum to a higher bracket faster. Exhibit 5 shows that the share of government of profit petroleum at various levels of IM; the share of the government increases to 50% once IM exceeds 2.5X. We do not factor in any negative impact of imposition of cess or royalty on crude produced by Cairn or exclusion of crude pipeline costs (capex and opex) from the upstream development cost.

GAIL—upside risk to subsidy amount with only moderate positive impact of higher crude oil prices. We believe our subsidy estimate of Rs13.5 bn for GAIL may be at risk if the government increases the share of upstream companies compared to the 33.33% assumed by us or if crude prices sustain at current levels. We note that FY2007 subsidy amount was Rs14.9 bn. GAIL has only moderate leverage to higher crude prices through higher LPG prices and possibly higher petrochemical prices; it is not a producer of crude oil other than very small production from a field in Cambay basin.

Gross under-recovery in FY2008E likely higher than FY2007 levels

Estimation of gross under-recovery in FY2008E

	FY2007	FY2008E
Government estimate of gross under-recovery	**494**	**549**
KIE estimated gross under-recovery in April-November 2007		352
KIE estimated gross under-recovery in November 2007 (a)		59
KIE estimated gross under-recovery in balance of FY2008 (b)		238
KIE estimated gross under-recovery in FY2008E		**589**
Subsidy loss on diesel in FY2007 or in November 2007 (Rs/l)	2.0	4.1
Subsidy loss on gasoline in FY2007 or in November 2007 (Rs/l)	1.6	4.0
Subsidy loss on LPG in FY2007 or in November 2007 (Rs/cylinder)	187	265
Subsidy loss on kerosene in FY2007 or in November 2007 (Rs/l)	16.5	17.8
Crude oil (Dated Brent) price in FY2007 or in October 20007 (US$/bbl)	**64.8**	**82.7**

Note:

(a) Based on October international product prices and November retail domestic price; Dated Brent price in October 2007 was US$82.7/bbl.

(b) Gross under-recovery for balance of FY2008 computed using November 2007E gross under-recovery.

Source: MOPNG, Kotak Institutional Equities estimates.

Gross under-recovery set to rise sharply in FY2008E

Estimation of subsidy under-recovery in FY2008E (Rs bn)

	2007	1HFY08	2HFY08E	2008E
Dated Brent crude oil price (US$/bbl)	65	69	82	76
Subsidy loss	**494**	**262**	**344**	**606**
Payment by government (oil bonds)	**241**	**113**	**122**	**235**
Share of BPCL	53	25	28	53
Share of HPCL	49	24	26	49
Share of IOCL	138	64	69	133
Net under-recovery of oil companies	**253**	**150**	**222**	**371**
Share of refining companies	—	—	—	—
Share of upstream companies	**205**	**87**	**115**	**202**
Share of ONGC	170	74	98	168
Share of GAIL	15	5	7	15
Share of Oil India	20	8	10	20
Net under-recovery of R&M companies (BPCL, HPCL, IOCL)	**48**	**62**	**107**	**169**
Pre-tax profits of R&M companies	**96**	**105**		

Source: Kotak Institutional Equities estimates.

ONGC's earnings are highly leveraged to crude prices but only if the subsidy amount remains constant
Earnings sensitivity of ONGC to key variables

	2008E			2009E			2010E		
	Downside	Base case	Upside	Downside	Base case	Upside	Downside	Base case	Upside
Exchange rate									
Rs/US$	39.0	40.0	41.0	38.0	39.0	40.0	37.0	38.0	39.0
Net profits (Rs mn)	221,161	232,039	242,916	230,554	241,602	252,649	241,374	252,579	263,784
Earnings per share (Rs)	103.4	108.5	113.6	107.8	113.0	118.1	112.9	118.1	123.3
% upside/(downside)	**(4.7)**		**4.7**	**(4.6)**		**4.6**	**(4.4)**		**4.4**
Average crude prices									
Crude price (US$/bbl)	70.0	72.0	74.0	68.0	70.0	72.0	68.0	70.0	72.0
Net profits (Rs mn)	220,373	232,039	243,699	229,756	241,602	253,443	240,856	252,579	264,299
Earnings per share (Rs)	103.0	108.5	113.9	107.4	113.0	118.5	112.6	118.1	123.6
% upside/(downside)	**(5.0)**		**5.0**	**(4.9)**		**4.9**	**(4.6)**		**4.6**
Cess									
Cess on domestic crude (Rs/ton)	3,090	2,575	2,060	3,090	2,575	2,060	3,090	2,575	2,060
Net profits (Rs mn)	223,909	232,039	240,169	233,408	241,602	249,796	244,290	252,579	260,868
Earnings per share (Rs)	104.7	108.5	112.3	109.1	113.0	116.8	114.2	118.1	122.0
% upside/(downside)	**(3.5)**		**3.5**	**(3.4)**		**3.4**	**(3.3)**		**3.3**
Natural gas prices									
Natural gas price ceiling (Rs/'000 cum)	3,750	4,250	4,750	4,000	4,500	5,000	4,250	4,750	5,250
Net profits (Rs mn)	226,477	232,039	237,597	236,206	241,602	246,994	247,317	252,579	257,838
Earnings per share (Rs)	105.9	108.5	111.1	110.4	113.0	115.5	115.6	118.1	120.5
% upside/(downside)	**(2.4)**		**2.4**	**(2.2)**		**2.2**	**(2.1)**		**2.1**

Source: Kotak Institutional Equities estimates.

Cairn's Rajasthan field's enterprise value is equally leveraged to crude prices, regulations
Enterprise value sensitivity of Cairn to key variables (US$ bn)

	Sensitvity of +1-year valuation		
	Enterprise value (US$ bn)	Equity value (Rs/share)	Change from base case (%)
Average crude prices (2013 and beyond)			
Dated Brent price (US$70/bbl)	5.6	165	16
Dated Brent price (US$60/bbl)	5.1	153	8
Dated Brent price (US$55/bbl)	4.9	148	4
Dated Brent price (US$50/bbl)	**4.7**	**142**	
Dated Brent price (US$40/bbl)	4.3	130	(12)
Dated Brent price (US$30/bbl)	3.8	117	(21)
Cess, royalty			
Royalty (Rs0/ton), Cess (Rs0/ton)	**4.7**	**142**	
Royalty (Rs0/ton), Cess (Rs927/ton)	4.4	133	(11)
Royalty (Rs0/ton), Cess (Rs2,575/ton)	4.0	123	(17)
Royalty (Rs481/ton), Cess (Rs927/ton)	3.3	104	(30)
Royalty (Rs481/ton), Cess (Rs2,575/ton)	2.6	87	(41)

Source: Kotak Institutional Equities estimates.

Maximum share of government of profit petroleum at 50% for Rajasthan block

Details of share of profit petroleum between the government and Cairn for Cairn's key assets

IM	Government share (%)
<1	**20**
>1, <1.5	20
>1.5, <2	30
<2, <2.5	40
>2.5, <3	**50**
>3	**50**

Note:
(a) IM = Investment Multiple.

Source: Company data.

Banking

Sector coverage view	Attractive

Company	Rating	Price, Rs 2-Nov	Target
SBI	ADD	2,252	2,000
HDFC	REDUCE	2,653	2,200
HDFC Bank	REDUCE	1,759	1,300
ICICI Bank	ADD	1,331	1,200
Corp Bk	BUY	453	470
BoB	BUY	373	375
PNB	BUY	541	620
OBC	REDUCE	239	240
Canara Bk	SELL	299	250
LIC Housing	ADD	355	345
Axis Bank	ADD	929	850
IOB	BUY	138	150
SREI	ADD	140	130
MMFSL	ADD	233	265
Andhra	BUY	90	120
IDFC	SELL	188	145
PFC	SELL	241	150
Federal Bank	ADD	394	410
J&K Bank	BUY	750	850
India Infoline	ADD	1,055	1,050
Indian Bank	REDUCE	163	145

Performance hit as banks rush for deposits at high rates while credit growth remains subdued

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- **Higher deposit growth in comparison to credit growth impacts banks NIMs**
- **Asset quality remained reasonably healthy for most banks. PNB, ICICI Bank and CBOP reported significant increase in gross NPLs on a sequential basis**
- **Valuations of public banks remain reasonable, cut in rates could provide trigger**

Private banks reported strong growth in earnings both on the back of equity issuance and improving operating metrics, but PSU banks disappointed across the board with few exceptions. Robust growth in deposits (likely high cost) and healthy but slower growth in credit hit PSU banks operating performance. In addition, the hike in CRR and higher issuance of MSS bonds by RBI to sterilize excess foreign inflows into the economy likely added to margin pressure. Most PSU banks under our coverage reported margin compression both yoy and qoq. However, reported profits were protected by lower provisions and higher treasury gains. BOB, Corporation Bank and Indian Bank were the public banks under coverage that managed to beat this trend and report good NII growth. Asset quality remained reasonably healthy for most banks, though PNB, ICICI Bank and CBOP reported significant increases in gross NPLs on a sequential basis. Valuations of public banks remain reasonable but their near-term performance would be impacted by concerns of further CRR hikes by RBI. A reduction in deposit rate (SBI has reduced rates by 25bps on special deposit scheme and withdrawn certain schemes) and rate cut by RBI will likely provide the necessary trigger to this performance.

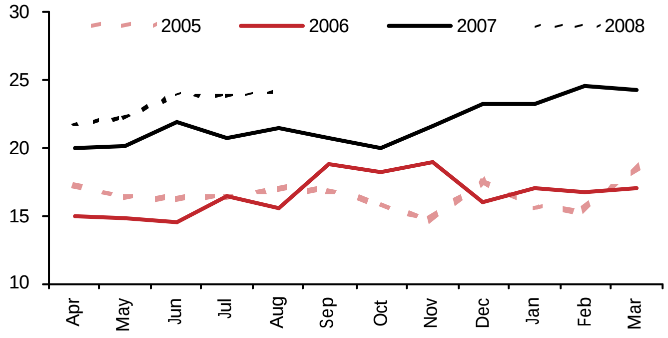
Deposit growth remains strong while growth in demand deposits has improved. The growth in deposits in the Indian banking system continues to be rather robust at 24% yoy driven by foreign inflows (see Exhibit 1), attractive deposit rates offered by the banks and fiscal sops for bank deposits. Fiscal sops for bank deposits likely led to a shift in postal deposits to the banking system. The higher deposit rates have also led to a shift in deposit composition from CASA to term deposit, thereby increasing overall costs for banks. The trend in low-cost deposits seems to be improving once again and this may support bank margins going forward (see Exhibit 2).

Credit growth slows down but remains healthy. The credit growth of banks has been fairly strong at around 22-24% yoy for the current fiscal, which is a slowdown from the 30% yoy growth witnessed over the last two years. The moderation in credit growth has been led by lower retail credit growth to 20%yoy as on August 2007 from 35%yoy as of December 2006, reflecting the regulatory measures implemented by RBI. Growth in the industry and agriculture sectors continues to be healthy at around 25% yoy (see Exhibit 4 and 5).

Sterilization measures of RBI impose a cost on banks. RBI has been using higher bond issuance under the market stabilization scheme (MSS) and hikes in CRR (up to 7.5% from 5% a year back) to sterilize the foreign fund flows to the economy. Both measures have an adverse impact on the financials of banks. The higher issuance of MSS bonds increases the supply of government paper and reduces the downward pressure on government yields, thereby impacting the AFS portfolios of banks. The CRR balances of banks with RBI do not earn interest income. Our economist, Dr Mridul Saggar, expects RBI to increase CRR by another 50 bps by FY2008 given the current monetary stance of RBI and the expected fund flows into the economy.

Exhibit 1: Deposit mobilization of banking industry continues to remain strong

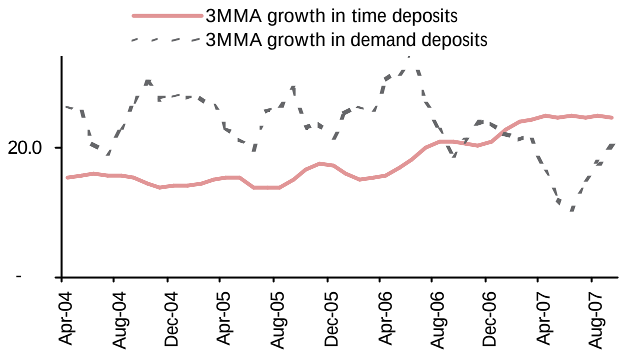
yoy growth in deposits (%)



Source: RBI.

Exhibit 2: Time deposit growth has been strong in comparison to demand deposits

3MMA yoy growth in time and demand deposits (%)



Source: RBI.

Exhibit 3: Strong deposit growth and lower CASA ratio across banks under coverage

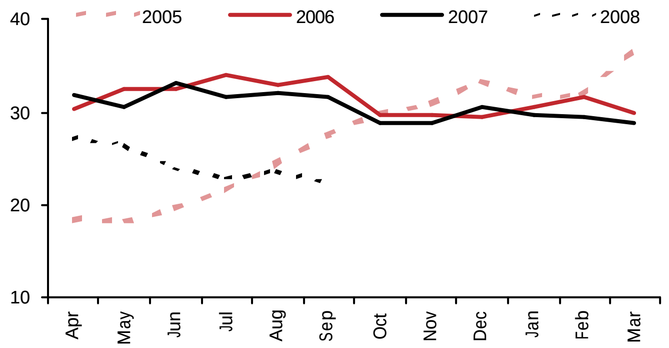
yoy deposit growth and CASA ratio of banks (%)

	Deposit growth						CASA ratio					
	1QFY07	2QFY07	3QFY07	4QFY07	1QFY08	2QFY08	1QFY07	2QFY07	3QFY07	4QFY07	1QFY08	2QFY08
Public banks												
Andhra Bank	29	9	15	22	23	37	37.7	39.8	37.0	34.5	33.4	32.0
Bank of Baroda	23	25	31	33	23	22	41.2	41.7	42.0	38.7	38.8	37.5
Canara Bank	25	19	26	22	16	19	36.5	34.5	32.0	32.0	31.0	31.0
Corporation Bank	27	28	33	29	27	20	32.5	29.8	31.0	34.1	28.7	28.7
Indian Bank	14	16	NA	15	20	22	36.1	35.1	NA	35.4	35.4	34.3
Indian Overseas Bank	19	20	20	36	32	37	38.2	37.7	36.0	34.9	32.8	31.8
Oriental Bank of Commerce	22	21	23	27	18	16	30.6	30.4	30.1	30.1	28.0	27.0
Punjab National Bank	16	17	23	17	22	17	48.6	48.7	47.0	46.2	44.0	43.0
State Bank of India	0	3	11	15	19	23	42.7	42.6	43.3	43.6	41.1	39.5
Old private banks												
Federal Bank	NA	NA	13	21	13	32	25.0	NA	28.4	25.6	25.0	25.0
J&K Bank	7	4	4	7	20	27	37.0	40.9	40.4	37.0	35.8	35.2
New private banks												
CBOP	191	41	46	58	55	69	35.0	33.0	34.0	31.0	28.0	25.0
HDFC Bank	58	40	30	22	35	44	52.6	52.2	54.9	57.7	51.5	52.5
ICICI Bank	61	57	47	40	26	20	21.9	22.5	23.9	21.6	22.6	25.4
Axis Bank	36	44	50	47	45	31	35.5	40.0	37.1	39.9	37.8	45.4

Source: Companies, Kotak Institutional Equities.

Exhibit 4: Loan growth has come down in FY2008 but still remains healthy

yoy growth in advances (%)



Note: Credit data in FY2005 impacted due to IDBI-IDBI Bank merger.

Source: RBI.

Exhibit 5: Retail sector loan growth moderates, while credit to industry continues to remain strong

yoy growth in credit (%)

	22-Dec-06	30-Mar-07	25-May-07	17-Aug-07
Agriculture	31.2	33.6	32.2	24.4
Industry	**27.8**	**25.9**	**26.4**	**24.6**
Retail	**34.9**	**28.8**	**23.9**	**19.8**
Housing	30.3	23.7	21.6	16.6
Consumer durables	23.3	4.2	23.2	4.1
Credit cards	43.2	45.1	45.0	45.9
Education loans	49.2	49.3	46.5	43.7
Real estate	66.7	69.9	69.7	52.9
Non-food bank credit	31.1	24.5	22.6	20.2

Source: RBI.

Exhibit 6: Loan growth comes off but still remains healthy

yoy growth in loans (%)

	1QFY07	2QFY07	3QFY07	4QFY07	1QFY08	2QFY08
Public banks						
Andhra Bank	20.4	23.6	23.5	25.6	27.1	29.2
Bank of Baroda	37.5	45.0	46.8	39.6	27.5	27.1
Canara Bank	34.2	26.8	28.6	24.0	18.0	15.5
Corporation Bank	37.4	38.5	30.7	25.0	17.5	16.6
Indian Bank	23.1	29.0	NA	28.4	22.0	20.6
Indian Overseas Bank	38.9	40.3	38.9	38.9	28.3	24.8
Oriental Bank of Commerce	32.5	28.7	25.0	35.2	23.8	21.3
Punjab National Bank	37.4	28.9	30.4	29.4	23.3	23.2
State Bank of India	23.1	18.8	28.0	28.8	29.4	26.7
Old private banks						
Federal Bank	NA	NA	29.5	26.9	22.9	23.5
J&K Bank	16.5	17.9	22.4	17.9	32.2	29.1
New private banks						
CBOP	208.1	64.0	65.5	71.8	60.2	66.8
HDFC Bank	47.7	34.9	32.8	33.9	32.7	45.6
ICICI Bank	50.3	45.1	40.9	34.0	34.7	33.3
Axis Bank	64.9	58.2	65.6	65.3	59.8	53.5

Source: Companies.

NIM of banks under pressure, could improve as credit demand picks up. Most PSU banks reported margin pressure in 2QFY08 results (see Exhibit 7). The higher deposit growth compared to loan growth, increase in low yielding investments, increase in funding costs (see Exhibit 8 and 9) and hike in CRR were likely key factors.

- BOB, Corporation Bank, Indian Bank and Federal Bank (among banks under our coverage) reported reasonable to healthy NII growth that was in contrast to this trend.
- Axis Bank, HDFC Bank and ICICI Bank benefited from their equity issuances and reported strong NII growth.
- Canara Bank was the worst amongst the banks under coverage and reported a 20% yoy decline in NII in the current quarter.

- NIM of banks could improve from the current level as loan growth improves in 2HFY08 (in comparison to 1HFY08) and as banks cut rates on their deposits to protect their margin.

Exhibit 7: Margin was under pressure for most banks

NIM and yoy growth in NII (%)

	NIM (%)						NII yoy growth (%)					
	1QFY07	2QFY07	3QFY07	4QFY07	1QFY08	2QFY08	1QFY07	2QFY07	3QFY07	4QFY07	1QFY08	2QFY08
Public banks												
Andhra Bank	3.8	3.8	3.6	3.5	3.5	3.2	22.2	14.7	22.8	25.1	8.0	4.2
Bank of Baroda	3.2	3.1	3.2	3.4	3.2	NA	16.3	22.9	17.8	27.1	19.6	7.8
Canara Bank	**3.2**	**3.2**	**3.1**	**3.2**	**2.5**	**2.4**	**13.8**	**21.6**	**8.4**	**7.7**	**(5.7)**	**(19.8)**
Corporation Bank	3.4	3.2	3.2	3.2	3.0	3.0	15.6	3.3	1.5	29.6	14.6	18.2
Indian Bank	3.3	3.6	NA	3.8	3.4	3.4	20.2	20.0	18.1	30.0	19.8	7.9
Indian Overseas Bank	4.0	4.0	3.7	4.2	3.7	3.4	19.1	18.3	15.1	42.0	23.2	3.3
Oriental Bank of Commerce	**2.6**	**2.5**	**2.8**	**2.7**	**2.7**	**2.4**	**2.0**	**2.1**	**6.6**	**10.8**	**7.8**	**(3.2)**
Punjab National Bank	4.1	4.2	4.2	4.1	3.8	3.9	18.8	14.4	19.7	20.6	6.6	0.3
State Bank of India	3.4	3.3	3.3	3.3	3.3	3.0	0.1	13.5	35.8	76.0	13.6	6.3
Old private banks												
Federal Bank	3.2	NA	3.3	3.1	3.2	3.2	10.0	25.0	19.3	32.4	21.5	23.2
J&K Bank	2.9	3.1	3.6	3.2	2.9	3.0	18.7	18.2	21.2	7.3	6.2	0.9
New private banks												
CBOP	4.7	4.7	4.7	4.4	3.6	3.7	122.3	43.5	40.1	43.1	17.3	34.7
HDFC Bank	4.1	4.0	4.0	4.5	4.2	4.2	56.1	38.1	38.5	51.2	27.5	44.5
ICICI Bank	2.5	2.5	2.6	2.7	2.3	2.5	52.2	47.4	31.9	36.4	16.2	26.6
Axis Bank	2.7	2.9	3.0	3.1	2.7	3.3	44.7	43.0	44.7	48.4	38.8	61.2

Source: Companies, Kotak Institutional Equities.

Exhibit 8: Cost of deposits increased across banks reflecting decline in CASA ratio and higher term deposit costs

Cost of deposit (%)

	1QFY07	2QFY07	3QFY07	4QFY07	1QFY08	2QFY08
Andhra Bank	5.0	5.1	5.1	5.9	6.2	6.6
Bank of Baroda	4.4	4.4	4.7	4.8	5.4	5.5
Canara Bank	5.0	5.1	5.3	5.5	NA	NA
Corporation Bank	4.7	5.0	5.2	5.3	6.6	6.4
Indian Bank	4.9	5.0	NA	5.2	5.6	5.8
Indian Overseas Bank	4.8	5.0	5.3	5.2	5.9	6.4
Oriental Bank of Commerce	5.3	5.6	5.7	6.1	6.6	6.9
Punjab National Bank	4.4	4.4	4.4	4.5	5.5	5.6
State Bank of India	4.5	4.5	4.6	4.8	5.4	5.5

Source:Companies, Kotak Institutional Equities.

Exhibit 9: Banks that reduced SLR investments reported higher NII growth
Incremental deposits, deposits and SLR (Rs bn)

	Incremental deposits				Incremental loans				SLR on incremental deposits				Excess investments in SLR over and above loan growth			
	3QFY07	4QFY07	1QFY08	2QFY08	3QFY07	4QFY07	1QFY08	2QFY08	3QFY07	4QFY07	1QFY08	2QFY08	3QFY07	4QFY07	1QFY08	2QFY08
Public banks																
Andhra Bank	36	53	(7)	37	20	27	(5)	28	9	13	(2)	9	7	14	0	(0)
Bank of Baroda	**46**	**126**	**(25)**	**89**	**67**	**60**	**(54)**	**120**	**12**	**32**	**(6)**	**22**	**(32)**	**35**	**35**	**(53)**
Canara Bank	97	106	7	21	82	78	(38)	7	24	27	2	5	(9)	2	43	9
Corporation Bank	**16**	**27**	**9**	**25**	**9**	**11**	**4**	**23**	**4**	**7**	**2**	**6**	**4**	**9**	**3**	**(4)**
Indian Bank	NA	NA	27	39	NA	NA	6	21	NA	NA	7	10	NA	NA	15	8
Indian Overseas Bank	22	95	15	81	29	38	7	27	5	24	4	20	(13)	33	4	33
Oriental Bank of Commerce	9	33	5	47	28	39	(3)	18	2	8	1	12	(21)	(14)	7	17
Punjab National Bank	18	96	27	74	53	89	(10)	58	5	24	7	18	(40)	(17)	30	(3)
State Bank of India	117	312	141	345	262	276	27	190	29	78	35	86	(174)	(42)	79	68
Old private banks																
Federal Bank	NA	30	(7)	32	5	13	(2)	15	NA	8	(2)	8	NA	10	(3)	9
J&K Bank	(1)	49	(5)	12	8	22	3	8	(0)	12	(1)	3	(9)	14	(6)	2
New private banks																
CBOP	11	23	12	32	10	18	7	20	3	6	3	8	(2)	(0)	2	3
HDFC Bank	**33**	**15**	**133**	**95**	**52**	**(11)**	**69**	**84**	**8**	**4**	**33**	**24**	**(28)**	**22**	**31**	**(13)**
ICICI Bank	**74**	**336**	**3**	**(25)**	**174**	**231**	**24**	**88**	**18**	**84**	**1**	**(6)**	**(118)**	**21**	**(22)**	**(107)**
Axis Bank	**19**	**79**	**23**	**30**	**32**	**45**	**44**	**34**	**5**	**20**	**6**	**8**	**(18)**	**14**	**(27)**	**(12)**

Source: Companies, Kotak Institutional estimates.

Other income of banks remained strong and supported profits in the current quarter

Most banks reported strong other income growth supported by higher treasury profits, better core income growth and higher recoveries (see Exhibit 10). Buoyant capital markets likely helped banks book treasury profits and improve their non-interest contribution. Core fee income growth was healthy, though it has come off from historical high levels reported by both PSU and private banks. We believe the high growth reflected the economic buoyancy as well as cuts in discount rates, which have likely played out fully, and banks will need to explore/widen product profile to improve fees. Even the forex income stream remained very high for most banks during the 2Q and reflected the volatility in the forex market. Recoveries from written-off accounts can be expected to moderate as most banks have recovered the ‘easy’ accounts and further recoveries could be more difficult.

Exhibit 10: Non interest income (ex-treasury) contribution of banks was rather strong

yoy growth in non -interest income (ex-treasury)

	1QFY07	2QFY07	3QFY07	4QFY07	1QFY08	2QFY08
Public banks						
Andhra Bank	27.3	19.5	18.2	64.3	15.4	15.7
Bank of Baroda	47.5	28.9	29.0	28.8	8.7	30.5
Canara Bank	19.0	(12.9)	(2.1)	41.2	32.4	23.2
Corporation Bank	19.2	11.4	27.2	14.8	10.0	8.5
Indian Bank	19.7	35.6	24.7	107.4	51.4	3.0
Indian Overseas Bank	18.3	35.4	26.7	21.7	27.4	31.0
Oriental Bank of Commerce	38.3	27.3	27.5	(21.4)	12.0	NA
Punjab National Bank	43.4	24.6	210.3	3.5	24.7	21.1
State Bank of India	7.2	36.1	(12.3)	37.3	1.6	12.7
Old private banks						
Federal Bank	NA	(15.9)	NA	(14.9)	NA	42.6
J&K Bank	15.0	30.9	(9.1)	35.5	62.6	41.1
New private banks						
CBOP	355.7	74.6	70.2	64.4	48.6	71.9
HDFC Bank	47.0	51.9	32.9	17.7	47.3	15.7
ICICI Bank	41.1	52.6	72.2	31.9	47.5	42.6
Axis Bank	60.6	65.7	58.9	58.9	47.1	54.5

Source: Companies, Kotak Institutional Equities.

Exhibit 11: Despite margin pressure, PAT growth was moderate to strong for most banks

yoy growth in PAT (%)

	1QFY07	2QFY07	3QFY07	4QFY07	1QFY08	2QFY08
Public banks						
Andhra Bank	36.7	10.2	5.8	0.1	21.2	3.2
Bank of Baroda	4.1	11.3	62.8	17.7	102.6	13.5
Canara Bank	2.2	18.1	1.9	2.3	26.0	11.0
Corporation Bank	16.8	20.3	27.2	18.1	22.8	27.1
Indian Bank	187.5	71.9	117.8	127.0	17.4	109.7
Indian Overseas Bank	21.2	25.9	25.1	41.7	20.9	28.0
Oriental Bank of Commerce	48.2	37.2	19.0	(56.2)	29.1	(24.0)
Punjab National Bank	2.6	19.7	16.0	(17.7)	15.7	6.6
State Bank of India	(34.7)	(2.5)	(4.5)	75.0	78.5	36.0
Old private banks						
Federal Bank	(17.5)	28.2	17.0	95.6	66.6	37.2
J&K Bank	28.8	52.8	65.6	98.6	43.1	35.4
New private banks						
CBOP	159.5	49.1	44.0	7.6	14.9	28.0
HDFC Bank	30.4	31.7	31.7	30.5	34.2	40.1
ICICI Bank	17.0	30.2	42.2	4.5	25.0	32.8
Axis Bank	30.2	30.2	40.2	39.6	45.2	60.5

Source: Companies, Kotak Institutional Equities.

Banks made lower provisions as asset quality remained healthy

- Lower provisions both on the credit and investment portfolio helped banks to maintain their provision burden within manageable limits in 2QFY08 and report higher profit numbers.
- Most banks continue to have reasonably healthy asset quality. Exceptions were CBOP, PNB and ICICI Bank, all of which reported a sharp increase in gross NPLs on a sequential basis (see Exhibit 12).
  - o CBOP faced issues on its two-wheeler portfolio, and also added fresh NPLs on account of Lord Krishna Bank merger
  - o PNB attributed the increase to delay in implementation of infrastructure projects and administrative issues in collection of certain loans rather than to a rise in delinquencies
  - o ICICI Bank reported an increase due to a deterioration of its non-collateralized loans and agriculture portfolio. The bank has indicated that it has de-emphasized this portfolio, which could help manage its asset quality
- Most public banks, with the exception of SBI and Canara Bank, have made some provisions to meet their transitional liabilities under the revised AS-15 guidelines. We view this as positive.

Exhibit 12: Asset quality of banks continues to remain healthy. PNB, CBOP and ICICI Bank reported a deterioration in asset quality
Gross and net NPLs of banks

	Gross NPLs (Rs bn)				Gross NPLs (%)				Net NPLs (Rs bn)				Net NPLs (Rs %)		
	1QFY07	4QFY07	1QFY08	2QFY08	1QFY07	4QFY07	1QFY08	2QFY08	1QFY07	4QFY07	1QFY08	2QFY08	1QFY07	1QFY08	2QFY08
Public banks															
Andhra Bank	4.2	4.0	4.2	4.1	1.2	1.4	1.5	1.4	0.2	0.5	0.5	0.6	0.1	0.2	0.2
Bank of Baroda	25.6	20.9	22.1	21.3	4.1	2.5	2.8	2.3	5.6	5.0	5.2	5.0	0.9	0.7	0.6
Canara Bank	17.4	14.9	14.8	15.9	2.2	1.5	1.6	1.7	7.3	9.3	8.4	9.4	0.9	0.9	1.0
Corporation Bank	6.2	6.2	6.4	6.2	2.4	2.1	2.1	1.9	1.4	1.4	1.4	1.1	0.6	0.5	0.4
Indian Bank	11.9	11.2	11.4	10.8	3.1	2.3	2.3	2.1	1.4	1.0	0.8	0.9	0.6	0.3	0.3
Indian Overseas Bank	6.5	5.5	5.5	5.2	2.6	1.9	1.8	1.6	1.8	2.6	2.4	1.8	0.5	0.5	0.4
Oriental Bank of Commerce	20.5	14.5	14.9	13.9	5.6	3.2	3.3	3.0	1.8	2.2	2.9	3.0	0.5	0.7	0.6
Punjab National Bank	30.9	33.9	36.3	47.2	4.0	3.5	3.8	4.6	2.7	7.3	9.4	18.9	0.4	1.0	1.9
State Bank of India	97.2	100.0	107.6	106.3	3.6	2.9	3.1	2.9	48.3	52.6	55.0	58.5	1.8	1.6	1.6
Old private banks															
Federal Bank	5.5	4.5	4.4	4.7	4.4	3.0	2.9	2.9	0.9	0.7	0.5	0.7	0.8	0.4	0.4
J&K Bank	3.5	5.0	4.9	4.8	2.6	2.9	2.8	2.6	0.9	1.9	1.7	1.6	0.7	1.0	0.9
New private banks															
CBOP	3.5	3.1	3.2	3.2	4.1	2.8	2.8	2.8	0.9	1.4	1.9	2.2	1.2	1.6	1.6
HDFC Bank	NA	6.6	NA	7.7	NA	1.3	NA	1.2	1.6	1.9	2.2	2.4	0.4	0.4	0.4
ICICI Bank	32.7	48.5	60.4	66.9	2.2	2.5	3.0	3.0	13.0	20.2	27.4	29.7	0.9	1.4	1.4
Axis Bank	4.0	4.2	4.8	4.9	1.3	1.0	1.0	1.0	1.9	2.2	2.4	2.5	0.7	0.6	0.6

Source: Companies.

Exhibit 13: Valuations of certain public banks remain attractive
Valuations of banks

	Reco.	Target price (Rs)	Price (Rs) 28-Aug-07	Market cap. US $bn	EPS (Rs) 2007	2008E	2009E	PER (X) 2007	2008E	2009E	ABVPS (Rs) 2007	2008E	2009E	APBR (X) 2007	2008E	2009E	RoE (%) 2007	2008E	2009E	Dividend Yield (%) 2007	2008E	2009E
Public banks																						
Andhra Bank	BUY	120	88	1.1	11.1	12.4	13.0	8.0	7.2	6.8	62	70	77	1.4	1.3	1.1	17.8	18.2	17.6	4.3	4.9	5.2
BoB	BUY	375	342	2.6	28.1	35.3	38.9	12.2	9.7	8.8	213	231	261	1.6	1.5	1.3	12.4	14.5	14.7	2.0	2.3	2.5
Canara Bank	SELL	250	293	2.6	34.7	30.5	37.4	8.5	9.6	7.8	173	206	232	1.7	1.4	1.3	16.3	12.8	10.5	2.0	2.2	2.4
Corporation Bank	BUY	470	426	1.2	37.4	40.5	44.2	11.4	10.5	9.6	244	271	305	1.7	1.6	1.4	15.0	16.3	16.3	2.1	2.5	2.9
Indian Bank	REDUCE	135	153	1.7	16.8	24.1	25.3	9.1	6.4	6.0	70	84	102	2.2	1.8	1.5	26.4	29.6	26.2	2.0	3.9	4.1
IOB	BUY	150	133	1.8	18.5	21.5	22.6	7.2	6.2	5.9	63	77	95	2.1	1.7	1.4	28.1	28.0	24.6	2.6	2.9	3.2
OBC	REDUCE	240	229	1.4	33.0	32.9	34.7	6.9	6.9	6.6	188	205	232	1.2	1.1	1.0	10.9	9.9	10.0	2.1	2.0	2.2
PNB	BUY	620	526	3.9	48.8	55.2	63.3	10.8	9.5	8.3	289	337	402	1.8	1.6	1.3	15.5	16.0	14.3	2.5	1.4	1.4
SBI	ADD																					
SBI incl. Banking Sub.	ADD	1,679	1,747	18.0	114.9	149.6	147.5	15.2	11.7	11.8	664	760	899	2.6	2.3	1.9	15.5	18.2	16.0	0.7	0.8	0.8
SBI standalone	ADD	1,313	1,381	14.2	74.9	106.1	98.0	18.4	13.0	14.1	454	513	616	3.0	2.7	2.2	14.6	18.8	15.7			
Old private banks																						
Federal Bank	ADD	375	320	0.8	34.2	43.4	46.4	9.4	7.4	6.9	161	228	253	2.0	1.4	1.3	21.2	15.5	13.5	1.2	1.6	2.1
J&K Bank	BUY	850	693	1.0	56.6	65.4	78.2	12.3	10.6	8.9	371	425	488	1.9	1.6	1.4	14.4	15.0	14.5	1.7	1.9	2.1
New private banks																						
HDFC Bank	REDUCE	1,250	1,152	10.5	35.7	47.2	61.2	32.2	24.4	18.8	201	335	381	5.7	3.4	3.0	19.5	17.9	16.9	0.6	0.8	1.1
ICICI Bank	ADD	1,200	862	25.0	34.6	35.7	47.3	24.9	24.1	18.2	270	426	459	3.2	2.0	1.9	13.4	10.4	10.7	1.2	1.0	1.4
ICICI standalone	ADD	653	457	13.2	17.2	24.2	37.9	26.5	18.9	12.1	36	26	16	12.7	17.9	27.9	0.0	0.0	0.0			
Axis Bank	ADD	850	598	6.0	23.4	32.3	41.3	25.5	18.5	14.5	106	239	276	5.6	2.5	2.2	21.0	17.6	15.7	0.9	1.1	1.4

Source: Bloomberg, Companies, Kotak Institutional Equities estimates.

Exhibit 14: Private bank stocks have delivered superior returns in recent months
Stock price performance—absolute and relative (%)

	Price 28-Aug-07	Rating	Change in price (%) 1 month	3 month	6 month	12 month	Ytd	Relative performance to sensex (%) 1 month	3 month	6 month	12 month	Ytd	52 week high	52 week low	% change from high
Public banks															
Andhra Bank	88	BUY	28	27	8	8	1	(26)	(19)	(24)	(37)	(28)	108	70	(17.8)
Bank of Baroda	342	BUY	3	19	45	23	43	(10)	(10)	1	(19)	(1)	353	189	(3.0)
Canara Bank	293	SELL	5	12	35	(0)	6	(8)	(11)	(6)	(35)	(26)	320	174	(8.4)
Corporation Bank	426	BUY	9	21	35	8	23	(5)	(9)	(6)	(29)	(14)	436	212	(2.3)
Indian Bank	153	REDUCE	(4)	8	33	NA	NA	(16)	(19)	(7)	NA	NA	178	77	(13.8)
Indian Overseas Bank	133	BUY	(9)	8	14	14	21	(20)	(19)	(20)	(25)	(16)	151	89	(11.4)
Oriental Bank of Commerce	229	REDUCE	(6)	4	16	(11)	1	(18)	(22)	(19)	(41)	(30)	264	157	(13.4)
Punjab National Bank	526	BUY	(3)	8	4	1	4	(15)	(19)	(27)	(33)	(28)	594	400	(11.5)
SBI	2,068	ADD	26	27	87	85	66	(5)	1	31	35	15	2,180	845	(5.1)
Old private banks															
Federal Bank	320	ADD	3	11	60	77	79	(10)	(16)	12	17	24	411	188	(22.1)
J&K Bank	693	BUY	0	18	6	67	25	(13)	(11)	(26)	10	(13)	800	450	(13.3)
New private banks															
CBOP	40	ADD	(7)	14	4	65	36	(19)	(14)	(27)	8	(5)	47	25	(15.3)
HDFC Bank	1,152	REDUCE	18	42	61	66	55	3	7	13	9	7	1,698	875	(32.2)
ICICI Bank	862	ADD	19	41	45	62	41	4	6	2	6	(2)	1,293	758	(33.3)
Axis Bank	598	ADD	22	49	96	108	96	7	12	37	37	36	960	399	(37.7)

Source: Bloomberg, Kotak Institutional Equities estimates.

Automobiles

Sector coverage view	Attractive

		Price, Rs	
Company	**Rating**	**2-Nov**	**Target**
Bajaj Auto	BUY	2,423	2,750
Maruti Suzuki	BUY	1,021	1,200

Oct 07 sales: Festival season fails to cheer—demand growth slower-than-expected

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- **Bajaj Auto: XCD on track—all set for volume growth in 2H**
- **Hero Honda: Competition from Bajaj heats up, cuts price to boost volume-growth**
- **TVS Motors: Volumes decline 27% yoy**
- **Maruti: Slower-than-expected festival demand growth**
- **Tata Motors: Modest growth in M&HCV volumes; Ace continues to be a winner**
- **M&M: Strong UV growth while tractor demand fails to pick up**

The beginning of the festival season failed to pep up volume growth as demand continued to be lower than the previous years. 2W volumes were better than the previous months but volume growth was slow as compared to the corresponding period for the last year. Bajaj's XCD has started to deliver recording strong volumes while Hero Honda has launched a new bike in the 150 cc segment. Passenger car sales were dominated by Maruti as its compact car and mid-car segments record a strong growth in volumes. M&HCV volumes have shown a positive growth in Oct'07 but not strong enough to signal a revival of the industry. We await signal across the auto industry as we enter into the second half of the festival season.

Bajaj Auto: XCD on track—all set for volume growth in 2H

Bajaj Auto reported a 1% yoy decline and a sharp 22% mom growth in motorcycle sales in Oct'07. Three-wheeler sales for Bajaj were down 2% yoy in Oct. Total exports grew 38% yoy for the month. Festival season sales have not been as per expectations. Volume growth has not been as per expectations up on account of (1) high base of the previous year and (2) slow-down prevailing in the industry. Bajaj's newly launched XCD is on track with its volume growth and is all set to drive Bajaj's success as expected. XCD has sold 63,000 vehicles since launch. Bajaj plans to ramp up capacity for XCD to 75,000 units/ month from November and expect it to be the largest selling bike in the country. Clearly, Bajaj's strategy of upgrading the entry-level customers seems to be on track to revive its fortunes. Entry-level 100 cc segment has become more competitive with Bajaj cutting Platina prices by Rs4,000. We believe going forward XCD would continue to drive Bajaj's success.

Hero Honda: Competition from Bajaj heats up, cuts price to boost volume-growth

Hero Honda's Oct'07 2-wheeler sales was flat on a yoy basis but grew 16% mom. The mom growth was on account of the beginning of the festival season this month—impressive considering the slowdown in the industry. However, in case of Hero Honda as well, volume growth was not as expected of festival-season sales. Hero Honda cut its entry-level prices by Rs2,020 in a bid to boost volumes ahead of the festival season. Besides, Hero Honda has launched a new 150 cc bike—'Hunk' to compete with Bajaj.

TVS Motors: Volumes decline 27% yoy

TVS Motors reported a 27% yoy decline in motorcycle sales for Oct'07 while its overall 2-wheeler volumes declined 9% yoy. TVS has been hit the hardest by the slowdown in the industry, fierce competition amongst peers and lack of product profile. TVS plans to launch a new 125 cc bike in Nov-Dec 2007. However, it is involved in a patent-infringement controversy with Bajaj which might delay the launch. We believe that TVS would be hit the hardest by competition and the slowdown in the industry.

Maruti: Slower-than-expected festival demand growth

Maruti's domestic sales grew at 15% yoy while exports at 5,157 vehicles grew 21% yoy in Aug. The volume-growth has note been as strong as in the previous year considering the festival season. The passenger car sales have been hit by higher interest rates and a general slowdown in the entire auto industry. The compact-car segment continued to grow 21% yoy for Maruti while the mid-car segment grew 55% yoy. The declining trend in Maruti-800 sales continued with volumes dropping 30% yoy. Recently, Hyundai launched its new car in the compact-car segment—"I-10"—to compete with the existing models of Maruti. We believe that Maruti's growth story would continue and its volumes would not be affected by Hyundai's new launch as its models continue to have a strong demand and Hyundai's new launch would cannibalize its existing Santro sales.

Tata Motors: Modest growth in M&HCV volumes; Ace continues to be a winner

Tata Motors recorded a 6% yoy growth in domestic M&HCV volumes while the LCV segment grew 16% yoy led by the success of the Ace vehicle. Overall domestic CV sales grew 16% yoy. CV exports grew 63% yoy. The high interest rates continued to hit CV sales as domestic sales have failed to pick up even in the traditionally high-volume season. The UV segment sales declined 1% yoy while passenger car sales grew 4% yoy in Oct'07. Tata Motors launched its new Safari Dicor in Oct'07 in a bid to boost UV sales.

M&M: Strong UV growth while tractor demand fails to pick up

M&M's UV volumes grew 42% yoy and 37% mom in Oct'07. This was led by a 37% yoy increase in its Scorpio volumes. Logan sales grew 1% mom in Oct'07 indicating that the car is not doing too well as its volumes have failed to grow as expected. M&M's tractor volumes have recorded a 16% yoy decline for the month as festival demand failed to pick up. We believe UV volumes for M&M should continue to do well as its Scorpio and Bolero have been doing well while tractor volume growth would be sluggish going forward.

Reported monthly sales of top two-wheeler companies - Oct 2007

	Oct-07	Oct-06	yoy %	Sep-07	mom %	YTD, FY2008	YTD, FY2007	yoy %
Bajaj Auto								
Geared Scooters	-	-	-	-		-	5,254	-100.0%
Ungeared Scooters	1,868	49	3712.2%	2,056	-9.1%	15,776	7,207	118.9%
Step thrus	-	-		-	0.0%	-	-	
Motorcycles	248,307	251,022	-1.1%	204,152	21.6%	1,273,388	1,442,271	-11.7%
Total 2-Wheelers	**250,175**	**251,071**	**-0.4%**	**206,208**	**21.3%**	**1,289,164**	**1,454,732**	**-11.4%**
3 Wheelers	28,001	28,507	-1.8%	26,288	6.5%	174,218	180,065	-3.2%
TVS Motor								
Motorcycles	67,752	92,328	-26.6%	53,991	25.5%	362,900	584,465	-37.9%
Scooty		22,836	-100.0%	27,199	-100.0%	121,884	159,792	-23.7%
Moped		27,161	-100.0%	33,901	-100.0%	165,346	193,037	-14.3%
Total 2-Wheelers	**129,614**	**142,325**	**-8.9%**	**115,091**	**12.6%**	**772,966**	**937,294**	**-17.5%**
Hero Honda								
Total 2-Wheelers	365,022	363,480	0.4%	314,567	16.0%	1,924,508	1,948,139	-1.2%

Source: Company, Kotak Institutional Equities.

4-wheelers Oct 2007 sales performance

	Oct-07	Oct-06	yoy %	Sep-07	mom %	YTD, FY2008	YTD, FY2007	yoy %
Tata Motors								
M&HCV	13,980	13,184	6.0%	14,129	-1.1%	82,756	90,086	-8.1%
LCV	13,123	10,170	29.0%	12,907	1.7%	77,218	67,148	15.0%
Domestic CV sales	27,103	23,354	16.1%	27,036	0.2%	159,974	157,234	1.7%
CV Exports	4,230	2,594	63.1%	3,015	40.3%	23,046	19,096	20.7%
Total CV	**31,333**	**25,948**	**20.8%**	**30,051**	**4.3%**	**183,020**	**176,330**	**3.8%**
UV	4,010	4,065	-1.4%	3,614	11.0%	25,450	24,914	2.2%
Passenger Cars	14,011	13,527	3.6%	14,682	-4.6%	103,834	107,302	-3.2%
Total	**49,354**	**43,540**	**13.4%**	**48,347**	**2.1%**	**312,304**	**308,546**	**1.2%**
Mahindra & Mahindra								
UVs	16,711	11,789	41.8%	12,246	36.5%	83,189	66,454	25.2%
LCVs	817	758	7.8%	930	-12.2%	6,290	4,679	34.4%
Logan	2,214			2,185	1.3%	14,716	-	
Tractors	11,186	13,384	-16.4%	8,668	29.0%	60,704	64,314	-5.6%
3 Wheelers	3,836	3,626	5.8%	3,208	19.6%	20,289	19,095	6.3%
Total	**34,764**	**29,557**	**17.6%**	**27,237**	**27.6%**	**185,188**	**154,542**	**19.8%**
Maruti Udyog						-	-	
Entry (A) segment	4,477	6,354	-29.5%	5,221	-14.3%	39,142	46,799	-16.4%
Van-segment	8,110	7,753	4.6%	6,350	27.7%	50,194	45,085	11.3%
Compact (B) segment	47,077	38,940	20.9%	46,216	1.9%	280,179	230,137	21.7%
Mid-size (C) segment	4,177	2,700	54.7%	4,885	-14.5%	29,351	18,660	57.3%
MUV	417	147	183.7%	414	0.7%	2,150	1,835	17.2%
Domestic	**64,258**	**55,894**	**15.0%**	**63,086**	**1.9%**	**401,016**	**342,516**	**17.1%**
Exports	5,157	4,269	20.8%	4,362	18.2%	29,393	20,278	45.0%
Total	**69,415**	**60,163**	**15.4%**	**67,448**	**2.9%**	**430,409**	**362,794**	**18.6%**

Source: Company, Kotak Institutional Equities.

Telecom

Sector coverage view	Cautious

		Price, Rs	
Company	**Rating**	**2-Nov**	**Target**
Bharti	REDUCE	895	775
Rcom	SELL	786	550
MTNL	SELL	167	135
VSNL	ADD	510	550
Idea Cellular	SELL	131	110

Further thoughts on spectrum, competition, pricing and valuations'Sell even now

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- **Spectrum tightening appears certain now; expect higher capex and opex**
- **New players and possible introduction of MNP negative for pricing; the war may have already started**
- **RCOM's spectrum across three entities raise issues about total spectrum, spectrum charges**

We elaborate on the ongoing spectrum debate and see several negative fallouts from the emerging environment. (1) We expect capex and opex to increase significantly versus our and street expectations if the government implements a stricter spectrum allocation policy. We see this as a near certainty now. (2) The entry of several new players consequent to the revised spectrum allocation policy and potential implementation of MNP regime will likely put additional pressure on pricing, profitability and returns. (3) We make a few observations on the valuations of Indian wireless stocks, which may become even more expensive based on the above-mentioned developments. As such, we find it hard to justify current stock prices on DCF even with our current set of rather benign assumptions. We retain our REDUCE, SELL and SELL ratings for Bharti, RCOM and Idea, respectively. Our 12-month DCF-based target prices are Rs775, Rs550 and Rs110, respectively.

Spectrum allocation policy largely sealed; to result in higher-than-expected capex and opex. It appears the government has largely decided in favor of a more stringent spectrum allocation policy (more number of subscribers for the same amount of spectrum). The DOT has accorded in-principle approval to the spectrum allocation criteria of the Telecom Engineering Center (TEC), which would result in practically no additional spectrum to incumbent operators for some time. Exhibit 1 gives our expectation for allocation of spectrum for various operators based on our subscriber estimates for end-FY2010E.

The COAI has challenged the recent decisions of the government/regulator on grounds of (1) violation of extant telecom policy, particularly regarding of grant of additional GSM spectrum to RCOM under a UASL license and (2) incorrect computation of spectrum requirement of extant operators in the 'revised' spectrum allocation policy. We think it may approach the higher courts, if required. In our opinion, it is generally difficult to challenge the government's decisions on policy issues given that the government has the right to reframe policies, if required.

Limited clarity on spectrum charges, dual spectrum usage and related charges. According to press reports, the government is mulling higher charges for spectrum (see Exhibit 2). If implemented, this may increase operating costs for operators. The development seems to be a retrograde one, in our view, compared to the license fee reduction being sought by operators and being considered by the government.

The allocation of additional spectrum for GSM service to RCOM raises an interesting dilemma regarding computation of spectrum charges for RCOM. We are not sure how the spectrum charges would be computed for RCOM under a UASL license. If the government (DOT) was to club the CDMA and GSM spectrum together, it would put RCOM in the higher bracket of spectrum charge for every circle. We compute a fairly significant impact on RCOM's EBITDA margin due to the 'combined' spectrum charges (see Exhibit 3). We will wait for more clarity on the contentious spectrum charge issue before reviewing our earnings models for Bharti and RCOM.

Pricing—the war may have already started. We see a potential snowballing of price competition over the next few months led by (1) entry of new players and (2) possible introduction of MNP in India. Already, Bharti has cut the outgoing tariff for local call on its Rs999 plan to Rs1/min from Rs2/min. There is no change to the Rs495 plan but customers under the Rs495 plan can migrate to the new tariff plan by making a one-time payment of Rs504. In a related development, Vodafone-Essar has announced a slew of 'Diwali' plans and prizes across circles. These include full recharge on high-end recharge vouchers in Chennai, Gujarat, Kerala, Mumbai and Tamil Nadu. Finally, as per press reports, RCOM may price its GSM plans significantly below current prices; however, this is contingent on it getting spectrum and will likely take time. Nonetheless, we expect RCOM to compete aggressively on pricing as and when it commences its pan-India GSM service.

We highlight that there is sufficient scope for pricing to come down given the very high profitability and returns in the Indian wireless market. We have long been skeptical about the sustainability of high profitability and returns in the Indian wireless market. We present (for the last time, we promise) our much-abused 'CROCI' argument in Exhibit 4, which shows the very high CROCI of Indian wireless companies.

Valuations—a dirty word in this market but we will talk about it. We make a few observations about current valuations of Indian wireless stocks.

1. **Valuation gap between RCOM and Bharti unlikely to sustain; ongoing developments negative for all operators although the relative impact may vary.** We do not think the current large valuation gap between RCOM and Bharti (see Exhibit 5) is justified for several reasons. (1) Bharti will likely accelerate the pace of subscriber additions while 'new' operators including RCOM wait for GSM spectrum to start operations in new circles. Bharti's superior net monthly additions for the past several months suggest that the trend will likely continue. (2) New subscribers are unlikely to be valuable given their low ARPU and usage (see Exhibit 6). New operators may not have too many 'good' subscribers to acquire by the time they start operations; we expect the Indian market to hit 310-315 mn by end-CY2008 from 200 mn at end-September 2007.

   Finally, we would highlight that a brutal price competition will be negative for everybody including RCOM. Pricing, profitability and returns may deteriorate putting the valuations of all operators at risk. We are anyway unable to justify the current valuations of any of the wireless operators even under our current set of quite benign assumptions.

2. **No need for M&A premium for any stock except for Spice Telecom (NC; likely receipt of spectrum may make this more attractive).** Although the government has not yet decided on the revised M&A guidelines proposed by the TRAI, we believe it may do so given the current rather lax guidelines for M&A. If the government was to accept the TRAI's recommendations about 40% limit for revenues and market share for the merged entity, we can rule out large-scale M&A in the Indian wireless segment; even 40% looks too high for us. We see no reason for any acquisition premium to the fair value of certain stocks as a section of the street has argued, particularly for Idea Cellular. We think Spice Telecom may be only real M&A candidate with its small footprint but high probability of getting spectrum (4.4 MHz) in 21 circles; as per our computations, Spice ranks 3-4 in the queue for spectrum.

3. **The bottom line is that the sector de-rating may have just started.** We note that all the three wireless stocks under our coverage will look even more expensive if capex and opex surprise negatively (higher versus expectations) and pricing erodes more versus expectations. As highlighted in our recent 2QFY08 results notes, our RPM and EPM assumptions in perpetuity look very rosy given the recent trends in RPM and EPM and the looming threat of increased competition (more players, MNP). As an example, we model Bharti's average RPM at Rs0.73/min for FY2008-17E (2QFY08 RPM = Rs0.78/min; 1QFY08 RPM = Rs0.82/min) and average EPM of Rs0.32/min for FY2008-17E (2QFY08 EPM = Rs0.32/min). Not surprisingly, our assumptions translate into average ROACE of 36.9% and average CROCI of 26.9% for FY2008-17E. However, incremental RPM and EPM for 2QFY08 was Rs0.5/min and Rs0.23/min as shown in Exhibit 7.

Fewer circles with spectrum deficiency for most players as per both TRAI and TEC recommendations

Assessment of spectrum 'position' of operators assuming spectrum allocation is based on estimated March-2010 subscribers (GSM only)

	Number of circles (#)			
	Presence	**Spectrum deficit (TRAI reco)**	**Spectrum deficit (TEC reco)**	**Spectrum deficit (old criteria)**
Bharti Airtel	23	14 (7 Metro + A, 7 B + C)	12 (4 Metro + A, 8 B + C)	23
Hutch	16	11 (7 Metro + A, 4 B + C)	9 (2 Metro + A, 7 B + C)	16
Idea	11	1 (1 Metro + A, 0 B + C)	1 (0 Metro + A, 1 B + C)	11
Aircel	9	5 (0 Metro + A, 5 B + C)	3 (0 Metro + A, 3 B + C)	8
BSNL	21	1 (0 Metro + A, 1 B + C)	3 (0 Metro + A, 3 B + C)	21
MTNL	2	0 (0 Metro + A, 0 B + C)	0 (0 Metro + A, 0 B + C)	2
Spice	2	0 (0 Metro + A, 0 B + C)	0 (0 Metro + A, 0 B + C)	2
Reliance GSM	8	1 (0 Metro + A, 1 B + C)	1 (0 Metro + A, 1 B + C)	6

Source: Kotak Institutional Equities estimates.

Summary of changes in spectrum usage charges proposed by TRAI and TEC

Changes to spectrum usage charges

Spectrum used	Existing charges	TRAI reco	TEC reco
MHz	% of AGR	% of AGR	% of AGR
4.4	2	2	2
6.2	3	3	3
8.0	**4**	**4**	**8**
10.0	**4**	**5**	**10**
12.0	**5**	**6**	**12**
15.0	**5**	**7**	**14**

Additional spectrum charges for spectrum beyond 6.2MHz (per press reports, source attributed to TEC)

Per year per additional MHz of spectrum (above 6.2 MHz)

Rs mn	
Metro	200
Circle A	150
Circle B	100
Circle C	75

Source: DOT, Press reports

Acceptance of TRAI and TEC recommendations on increased spectrum usage charges could impact RCOM's FY2009 EDITDA margins by 1.8-8.3% pts

If TRAI recos are accepted	
FY2009 spectrum charges (TRAI reco)	9,275
Current estimated spectrum charges (Kotak)	4,219
Impact (Rs mn)	**(5,056)**
EBITDA margin impact (% pts)	**(1.8)**
If TEC recos are accepted	
FY2009 spectrum charges (TEC reco)	27,028
Current estimated spectrum charges (Kotak)	4,219
Impact (Rs mn)	**(22,809)**
EBITDA margin impact (% pts)	**(8.3)**

	Current spectrum		Likely GSM spectrum	Combined spectrum	AGR FY2009	Spectrum charges		Spectrum charges		Additional spectrum charges	Additional spectrum charges
	MHz		MHz	MHz	Rs mn	% of AGR		Rs mn		Rs mn	Rs mn
Metro	**GSM**	**CDMA**		**GSM + CDMA**		**TRAI**	**TEC**	**TRAI**	**TEC**	**Per MHz above 6.2**	
Calcutta	6.2	5.0		11.2	8,015	6	12	481	962	200	1,000
Chennai		5.0	4.4	9.4	4,400	5	10	220	440	200	640
Delhi		5.0	4.4	9.4	15,753	5	10	788	1,575	200	640
Mumbai		5.0	4.4	9.4	18,309	5	10	915	1,831	200	640
Circle A											
Andhra Pradesh		5.0	4.4	9.4	14,464	5	10	723	1,446	150	480
Gujarat		3.8	4.4	8.2	10,319	5	10	516	1,032	150	293
Karnataka		5.0	4.4	9.4	11,094	5	10	555	1,109	150	480
Maharashtra		5.0	4.4	9.4	13,566	5	10	678	1,357	150	480
Tamil Nadu		5.0	4.4	9.4	9,481	5	10	474	948	150	480
Circle B											
Haryana		3.8	4.4	8.2	2,659	5	10	133	266	100	195
Kerala		5.0	4.4	9.4	7,763	5	10	388	776	100	320
Madhya Pradesh	6.2	5.0		11.2	11,761	6	12	706	1,411	100	500
Punjab		3.8	4.4	8.2	3,930	5	10	197	393	100	195
Rajasthan		3.8	4.4	8.2	6,756	5	10	338	676	100	195
Uttar Pradesh (east)		5.0	4.4	9.4	9,032	5	10	452	903	100	320
Uttar Pradesh (west)		5.0	4.4	9.4	6,700	5	10	335	670	100	320
West Bengal and A&N islands	6.2	3.8		10.0	4,808	5	10	240	481	100	375
Circle C											
Assam	6.2			6.2	2,962	3	3	89	89	75	-
Bihar	8.0	5.0		13.0	10,891	7	14	762	1,525	75	510
Himachal Pradesh	6.2	2.5		8.7	1,109	5	10	55	111	75	188
North East	4.4			4.4	1,049	2	2	21	21	75	-
Orissa	6.2	3.8		10.0	4,166	5	10	208	417	75	285
J&K		2.5	4.4	6.9	26	4	8	1	2	75	53
Total					**179,014**			**9,275**	**18,441**		**8,588**

Note:
(a) Assuming spectrum charges are applied based on combined CDMA + GSM spectrum (including current GSM circles)
(b) FY2009 AGR distribution across circles in the same proportion as Jun '07 quarter

Source: Kotak Institutional Equities estimates.

The wireless business in India generates remarkably high CROCI

CROCI of wireless segment Bharti and RCL and of Idea (%)

	Jun-05	Sep-05	Dec-05	Mar-06	Jun-06	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07
Bharti Airtel										
EBIT (Rs mn)	3,932	4,341	5,319	5,522	6,961	8,085	9,184	11,424	13,321	14,058
Tax rate (%)	13.6	8.9	13.4	7.4	11.1	12.8	14.8	9.0	19.0	6.5
EBIT*(1-t) (Rs mn)	3,396	3,956	4,604	5,113	6,190	7,052	7,821	10,398	10,788	13,145
Add: Depreciation	2,141	2,608	2,613	3,224	3,380	4,094	4,945	5,180	5,766	6,670
Cash return (Rs mn)	5,537	6,564	7,217	8,337	9,570	11,146	12,766	15,578	16,554	19,815
Annualized cash return (Rs mn)	22,148	26,256	28,870	33,348	38,281	44,582	51,063	62,313	66,216	79,259
Gross cash invested (Rs mn)	124,643	133,258	141,555	159,227	177,633	205,084	220,672	231,414	264,494	292,954
CROCI (%)	**17.8**	**19.7**	**20.4**	**20.9**	**21.6**	**21.7**	**23.1**	**26.9**	**25.0**	**27.1**
Reliance Communications										
EBIT (Rs mn)					3,998	5,131	5,542	6,991	9,284	10,236
Tax rate (%)					5.0	0.8	1.4	1.4	7.8	5.1
EBIT*(1-t) (Rs mn)					3,797	5,088	5,465	6,891	8,561	9,716
Add: Depreciation					3,573	4,163	4,751	4,520	4,108	4,634
Cash return (Rs mn)					7,370	9,251	10,216	11,411	12,669	14,350
Annualized cash return (Rs mn)					29,478	37,004	40,864	45,642	50,676	57,401
Gross cash invested (Rs mn)					155,117	170,100	182,190	192,050	207,023	256,708
CROCI (%)					**19.0**	**21.8**	**22.4**	**23.8**	**24.5**	**22.4**
Idea Cellular										
EBIT (Rs mn)							1,905	2,599	3,241	3,121
Tax rate (%)							3.2	1.0	0.5	0.7
EBIT*(1-t) (Rs mn)							1,845	2,573	3,224	3,100
Add: Depreciation							1,801	1,761	1,887	2,007
Cash return (Rs mn)							3,646	4,334	5,111	5,107
Annualized cash return (Rs mn)							14,584	17,336	20,446	20,430
Gross cash invested (Rs mn)							66,187	75,661	86,670	98,972
CROCI (%)							**22.0**	**22.9**	**23.6**	**20.6**

Source: Companies, Kotak Institutional Equities estimates.

RCOM is trading at a 35% FY2010E EV/EBITDA premium to Bharti, unsustainable in our view

Indian telecom companies valuation analysis, March fiscal year-ends, 2006-2010E

	Price (Rs)	Target price	P/E (X)					EV/EBITDA (X)				
	2-Nov-07	(Rs)	2006	2007	2008E	2009E	2010E	2006	2007	2008E	2009E	2010E
Bharti	895	775	83.7	41.8	25.8	19.6	16.1	42.0	23.4	15.2	11.0	**8.7**
Idea	131	110	148.2	60.2	30.8	24.0	20.7	35.3	25.3	16.8	12.5	**9.5**
MTNL	167	135	25.2	23.3	21.2	19.0	17.6	12.0	9.2	6.7	6.6	**6.0**
RCL	786	550	362.4	55.4	31.1	24.5	19.7	71.6	29.9	19.7	14.5	**11.7**
VSNL	510	550	27.3	29.7	32.0	26.7	22.6	15.3	14.7	14.6	12.3	**10.4**

	KS	Market cap.	Revenues (Rs bn)					EBITDA (Rs bn)				
	rating	(US$ bn)	2006	2007	2008E	2009E	2010E	2006	2007	2008E	2009E	2010E
Bharti	REDUCE	41.4	117	184	271	365	442	42	74	116	159	196
Idea	SELL	8.4	30	44	68	97	127	11	15	23	32	44
MTNL	SELL	2.6	55	49	51	55	59	7	9	11	11	12
RCL	SELL	39.2	106	145	200	275	342	23	57	86	118	147
VSNL	ADD	3.5	38	40	42	46	53	9	9	9	11	13

	Net income (Rs bn)					EPS (Rs)				
	2006	2007	2008E	2009E	2010E	2006	2007	2008E	2009E	2010E
Bharti	20	41	65	86	104	10.7	21.4	34.6	45.7	55.5
Idea	2	5	11	14	17	0.9	2.2	4.3	5.5	6.3
MTNL	4	4	3	5	5	6.6	7.2	7.9	8.8	9.5
RCL	5	31	55	69	86	2.2	14.2	25.3	32.1	39.9
VSNL	5	5	5	5	6	18.6	17.2	15.9	19.1	22.6

Source: Bloomberg, Kotak Institutional Equities estimates

Lifelong subscribers are not very valuable; we value a subscriber at about US$75

NPV and IRR analysis for a prepaid subscriber under the recently announced Rs495 lifelong validity plan (Rs)

Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	
Revenues	**1,200**	**1,320**	**1,440**	**1,512**	**1,588**	**1,667**	**1,750**	**1,838**	**1,930**	**2,026**	**2,128**	**2,234**	**2,346**	**2,463**	**2,586**	**2,715**	
Monthly ARPU	100	110	120	126	132	139	146	153	161	169	177	186	195	205	216	226	
EBITDA margin (%)	**45**	**45**	**45**	**45**	**45**	**45**	**45**	**45**	**45**	**45**	**45**	**45**	**45**	**45**	**45**	**45**	
Tax rate (%)	11	11	11	11	11	12	12	12	12	12	34	34	34	34	34	34	
Operating cash flow	505	553	601	630	660	686	719	753	789	827	711	743	697	732	768	807	
Initial capex	(2,800)																
Maintenance capex									(56)	(56)	(56)	(56)	(56)	(56)	(56)	(272)	
Change in working capital	441	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	
Free cash flow	**(1,854)**	**553**	**601**	**630**	**660**	**686**	**719**	**753**	**733**	**771**	**655**	**687**	**641**	**676**	**712**	**535**	**4,280**
Terminal growth rate (%)	0	5															
WACC (%)	12.5	12.5															
IRR	**34.3%**	**34.8%**															
NPV (Rs)	**2,805**	**3,238**															
NPV (US$)	**70**	**81**															

Note:

(a) Maintenance capex taken as 2% of initial capex.

(b) Life of equipment taken at 12 years for computation of book depreciation.

Source: Kotak Institutional Equities estimates

Revenue per incremental minute declined substantially in the Sep '07 quarter

Bharti's revenue and EBITDA per incremental minute, 2QFY07-2QFY08

	Mar-06	Jun-06	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07
Revenues (Rs mn)	24,134	28,411	33,022	37,579	42,431	46,976	50,579
Total minutes of use (mn min)	23,187	28,194	33,844	41,305	49,240	57,125	64,375
Revenue per minute or RPM (Rs/min)	1.04	1.01	0.98	0.91	0.86	0.82	0.79
Incremental RPM (Rs/min)		**0.85**	**0.82**	**0.61**	**0.61**	**0.58**	**0.50**
EBITDA (Rs mn)	8,746	10,341	12,179	14,129	16,604	19,087	20,728
EBITDA per min or EPM (Rs/min)	0.38	0.37	0.36	0.34	0.34	0.33	0.32
Incremental EPM (Rs/min)		**0.32**	**0.33**	**0.26**	**0.31**	**0.31**	**0.23**

Source: Company data, Kotak Institutional Equities estimates.

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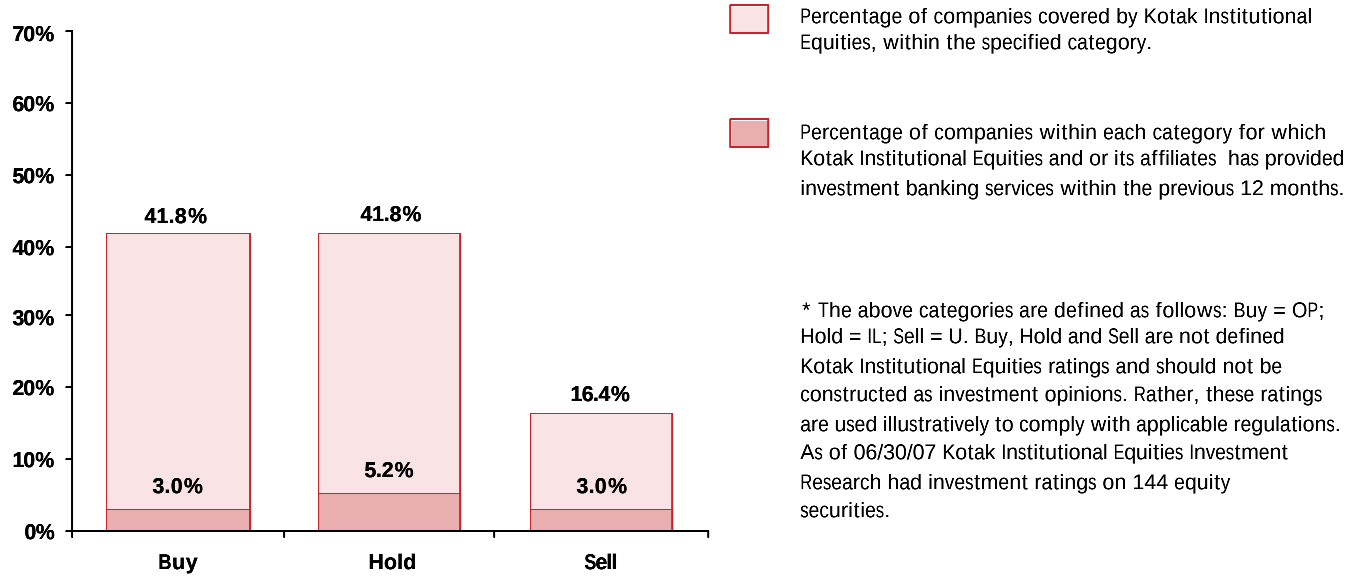

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Source: Kotak Institutional Equities. As of September 30, 2007

Ratings and other definitions/identifiers

New rating system

Definitions of ratings

BUY. We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.
ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.
REDUCE: We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.
SELL: We expect this stock to underperform the BSE Sensexby more than 10% over the next 12 months.

Old rating system

Definitions of ratings

OP = Outperform. We expect this stock to outperform the BSE Sensex over the next 12 months.
IL = In-Line. We expect this stock to perform in line with the BSE Sensex over the next 12 months.
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