kotak® Institutional Equities

INDIA DAILY

July 14, 2008

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Telecom: June GSM net adds—mobile subs continue to soar

News Roundup

Corporate

- The US government has filed a suit against **Ranbaxy Laboratories**, India's largest pharmaceutical company, and its US-based consultant Parexel Consulting for concealing and forging crucial data to get a favorable judgment on an ongoing investigation into the sale of sub-standard drugs in that country. (BS)
- **Reliance-Anil Dhirubhai Ambani Group** is looking for acquisitions to start its cement business much before it completes its 4,000 MW mega power project at Sasan in eastern Madhya Pradesh, which is to provide the fly ash that is used to make cement. (BS)
- The $29 bn **Tata Group** is in the process of making a major private equity push through its flagship financial services company, Tata Capital Ltd. The plans being drawn up relate to setting up PE funds aimed at mid-cap, technology and healthcare sectors. (FE)
- **Wipro Infotech**, the Asia technology arm of Wipro Technologies, is looking at closing a few deals in the Middle East and India worth $100 mn each. The company is expecting a growth of 50% from the Indian market, and a three-digit growth from the Middle East. (FE)
- World's biggest steelmaker **ArcelorMittal**'s India plants are making good progress and are scheduled to start operations by 2012, CFO of the world's top producer of the alloy Aditya Mittal has said. (BS)

Economic and political

- The finance ministry has made out a case for a major revision in the policy on foreign borrowings to allow an investment of over $15 bn by foreign portfolio investors in rupee-denominated bonds issued by Indian corporates. (ET)
- The Bombay Stock Exchange move to buy a 26% stake in the Ahmedabad-headquartered National Multi Commodity Exchange is likely to take some more time to materialize as the BSE board has decided to seek more clarification from the NMCE management and its advisor. BSE is now going to initiate discussions with NMCE on some aspects of the deal. (FE)

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

EQUITY MARKETS

		Change, %		
India	**11-Jul**	**1-day**	**1-mo**	**3-mo**
Sensex	13,470	(3.3)	(11.3)	(14.8)
Nifty	4,049	(2.7)	(10.4)	(15.3)
Global/Regional indices				
Dow Jones	11,101	(1.1)	(9.8)	(9.8)
FTSE	5,262	(2.7)	(9.3)	(9.8)
Nikkie	13,186	1.1	(5.6)	2.1
Hang Seng	22,357	0.8	(1.0)	(6.1)
KOSPI	1,578	0.7	(9.7)	(9.7)

Value traded - India

			Moving avg, Rs bn	
	11-Jul		**1-mo**	**3-mo**
Cash (NSE+BSE)	175.4		175.5	190.7
Derivatives (NSE)	501.5		457.8	410
Deri. open interest	722.1		794	610

Forex/money market

		Change, basis points		
	11-Jul	**1-day**	**1-mo**	**3-mo**
Rs/US$	42.9	0	(14)	289
6mo fwd prem, %	0.7	(25)	71	24

Net investment (US$mn)

	10-Jul		**MTD**	**CYTD**
FIIs	(86)		(123)	(6,618)
MFs	48		129	2,461

Top movers -3mo basis

		Change, %		
Best performers	**11-Jul**	**1-day**	**1-mo**	**3-mo**
Chambal Fert	67	(4.0)	(26.6)	33.8
Ingersoll Rand	360	(5.8)	26.2	28.6
i-Flex	1,333	(9.1)	0.9	22.4
Ballarpur Ind	32	(1.9)	(12.8)	21.2
Ranbaxy	532	(1.2)	(6.1)	19.6
Worst performers				
Wockhardt	182	(1.1)	(25.4)	(35.8)
Tata Motors	400	0.2	(22.4)	(35.7)
Moser Baer	109	(4.5)	(30.3)	(35.2)
BPCL	256	(8.4)	(4.2)	(35.0)
Essel Propack	26	(1.9)	(14.9)	(34.8)

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Technology

INFY.BO, Rs1677	
Rating	BUY
Sector coverage view	Neutral
Target Price (Rs)	2,100
52W High -Low (Rs)	2142 - 1212
Market Cap (Rs bn)	962.5

Financials

March y/e	2008	2009E	2010E
Sales (Rs bn)	166.9	214.9	260.2
Net Profit (Rs bn)	45.4	58.6	67.8
EPS (Rs)	79.1	102.1	118.1
EPS gth	*18.0*	*29.1*	*15.7*
P/E (x)	21.2	16.4	14.2
EV/EBITDA (x)	16.8	12.7	10.2
Div yield (%)	2.0	1.5	1.7

Shareholding, March 2008

	Pattern	% of Portfolio	Over/(under) weight
Promoters	16.5	-	-
FIIs	52.5	5.7	3.5
MFs	2.9	1.7	(0.5)
UTI	-	-	(2.2)
LIC	3.7	1.9	(0.2)

Infosys Technologies: When valuation becomes a catalyst. BUY

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- **Pricing—clients test the waters but offshore names led by Infosys maintaining reasonable discipline**
- **Extent of decline in BT revenues surprising; account may growth marginally before declining again**
- **Robust September quarter guidance, a positive in our view**
- **Maintain BUY rating. Target price Rs2,100**

We are somewhat disappointed with Infosys' weak 1QFY09 revenue growth and unchanged FY2009 revenue (US$) guidance; though a strong September quarter guidance mitigated some of the concerns on demand and reduced the back-ended nature of FY2009E revenues. We are also impressed with the quality of results including stable pricing despite adverse change in business mix (and some decline in pricing among BFSI clients), reasonable recruitment, good ex-BT revenue growth and a surprise growth in financial services revenues. Other factors such as improvement in client metrics, receivables collection cycle and predictability of operating cash emphasize the company's ability to manage challenging external environment. Lack of upgrades in street estimates is bound to disappoint; positive catalysts for near-term stock performance would accrue from solid September quarter results, improvement in macro economic environment or attractive valuations (which appears to be the case). Valuations at 16.4X FY2009E and 14.2X FY2010E earnings are undemanding; implied free cash growth to perpetuity is also a modest 7.5%. Maintain BUY; reduce target price to Rs2,100 (Rs2,200 earlier) on the back of revision in earnings estimates.

Valuations—premium for predictability and quality. In the current environment of uncertainty, we find Infosys' overall performance and execution quite remarkable and something deserving significant premium. While the profitability of Infosys and predictability of client metrics is well known, its ability to generate operating cash flows is truly remarkable as well. Exhibit 1 shows the cash flows from operating activities has remained remarkably stable at 27-28% of revenues for the last six years. The aberration in FY2004 and FY2005 gets normalized on normalizing cash flows over a two-year block. We believe there would be very few companies globally, that are able to manage their operations in such a consistent manner. This predictability on cash generation makes calculation of implied FCF growth to perpetuity fairly straightforward; the number stands at 7.5% at the current market price, reasonable in our view.

Pricing—select clients test the waters but offshore names led by Infosys maintaining reasonable discipline. Based on our channel checks, we believe the pricing discipline still exists among Tier 1 players (though one of them may be getting a bit edgy). We are seeing instances of investment banking clients testing the waters for contract repricing. Infosys also alluded to sporadic pricing renegotiations in the financial services vertical. This reflects in a sharp 340 bps qoq decline of operating margin of financial services vertical (see Exhibit 2) versus 170 bps for others. We admit that qoq trends in vertical profitability may be volatile but believe the same does represent the trend in the current operating environment. **Our channel checks also indicate a sharp decline in pricing with one large insurance client of Infosys**. Despite this change and adverse shift in business mix, Infosys has managed realizations for the June quarter. This in our view also demonstrates increase in pricing and ramp up by clients added at higher than corporate average rates. Infosys has further guided for stable pricing for the rest of the year, positive in our view.

Moderately weak 1Q revenues; BT account would be stable for two quarters before declining again. Infosys 1QFY09 revenues grew 1.1% to US$1,155 mn, 0.9% lower than our expectations. Revenue growth was impacted by a sharp US$26 mn ramp down (22% qoq decline) from the British Telecom relationship. Revenues excluding BT grew at a reasonable 3.8% qoq led by manufacturing vertical (13.5%) and banking and finance vertical (+2.8% qoq to US$398 mn). EBITDA margin declined 200 bps to 30.5%, impacted largely by wage revisions (impact of 220 bps), lower utilization (150 bps) and visa charges (70 bps) but offset by rupee depreciation (+250 bps). Net income grew 3.4% qoq to Rs12.71 bn (excluding tax reversal of Rs310 mn). Net income was impacted by forex losses of Rs800 mn (versus Rs450 mn in 4QFY08). Net employee addition was 3,192 with bulk of them being at the lateral level. DSO's declined to 69 days from 72 days at end-March 2008.

Extent of decline in BT revenues surprising. We are unable to reconcile the extent of decline in BT revenues (US$ 26 mn in June 2008 quarter) especially after the sharp ramp up in the previous quarters. We summarize our thoughts: (1) The decline of revenues implies reduction in billing of 1,200 FTEs assuming that blended pricing is similar to the corporate average; (2) the decline in revenues cannot be completely a market share loss. We do not think that Tech Mahindra would have benefited to the entire extent of loss of revenues from BT. In fact Tech Mahindra had only US$100 mn of incremental business in the recent deal announcement over a period of five years. Even that business win would not have completed the transition in our view; (3) we also think that the revenues may not have been lost to HCLT. In our view, HCLT's application deal with BT was signed only mid-way through the previous quarter; (4) we think that BT revenues for Infosys may increase marginally over the next two quarters after which it may decline again led largely by likely consolidation of applications for BTGS with Tech Mahindra and Accenture consortium.

Robust revenue growth guidance for September quarter, FY2009E EPS guidance reset to Rs101. Infosys surprised us positively with a strong revenue growth guidance of 6.1% qoq (upper end) to US$1,225 mn. We believe the growth would be led by telecom service provider clients (other than British Telecom), healthcare and utilities verticals. The guidance also reduces the back-ended nature of FY2009E revenues. Implied growth to achieve FY2009E revenue growth stands at 5.9% for 3Q and 4Q. We incorporate the Q1 revenue disappointment in our numbers and reduce FY2009E revenue growth to 22.5% from 24.5% earlier. We also reduce our FY2010E revenue growth assumption to 22.6% from 23.5% earlier.

Infosys has reset its FY2009 EPS guidance to a Re/US$ rate of 43 from 40 earlier. The company as a result has raised EPS guidance to Rs101.06 from Rs93.9 earlier. EPS growth stands revised to 27.5%. The company has guided for lower effective tax rate of 14-14.5% from 15-15.5% earlier (due to lower non-operating income). We reduce our FY2009 EPS estimate moderately to Rs102.1 (Rs102.8 earlier) and FY2010E EPS to Rs118.1 from Rs119.6 earlier.

Several levers to manage operating margin even in a scenario of moderate pricing pressure. Exhibit 3 highlights the levers available for Infosys to offset any adverse movement in pricing. We believe utilization provides 110 bps cushion and variable compensation 300 bps. Exhibit 4 gives our stress case EPS for FY2010, assuming 5% pricing decline (both onsite and offshore) in the worst case scenario. Our EPS works out to Rs104 in such a case as against our current base case of Rs118.

Past experience has suggested that pricing declines in a recessionary environment. Perhaps a stable pricing might indicate better bargaining power and more rational spends by clients on IT, leading to rational pricing behavior. We however, would highlight that Infosys had guided for stable pricing for FY2002 at the time of initial annual guidance in April 2001, but had to change its view (to negative pricing environment) within a quarter on account of rapid deterioration in external environment (full-blown dot-com bust). A wider client base, a more rational pricing environment, and better bargaining power reduce the risk of a repeat, in our view.

Several positives to look up to. We discuss key metrics that provide us with comfort (1) hiring was robust at 3,200 (net, 7,182 gross) and consistent with the guidance. Infosys has retained its FY2009 gross hiring target of 25,000, (2) billing rates remained steady, despite some turbulence in financial services vertical; guidance remains for stability in pricing from current levels, (3) growth from other verticals compensated for weak BT revenues and (4) strong Sep '08 quarter revenue growth guidance reflecting improving spends and that BT decline may not be meaningful from hereon.

However, decelerating volume growth becoming a source of concern. Exhibit 5 gives the yoy change in volumes and blended realization for Infosys over the past 17 quarters. Infosys reported 18.6% yoy volume growth (IT services only) in the June 2008 quarter, the lowest ever in several years. While this may partly reflect the company's stated focus on profitable growth (not chasing volumes at the expense of pricing), another two or three quarters without a substantial uptick in volume growth trajectory will likely test the company's strategy. We do not rule out Infosys yielding to pricing discounts if the volumes do not pick up over the next couple of quarters.

Infosys--operating cash flow as % of revenues, March fiscal year-ends, 2003-2008 (US$ mn)

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

Note
(a) Cash generated includes other income.

Source: Company, Kotak Institutional Equities.

Pricing pressure reflected in the sharp operating margin decline in the BFSI vertical

	1QFY08	2QFY08	3QFY08	4QFY08	1QFY09
Revenues (US$ mn)					
BFSI	335	373	399	387	398
Non-BFSI	593	649	685	755	757
Total	928	1022	1084	1142	1155
Operating profit (US$ mn)					
BFSI	89	117	134	123	113
Non-BFSI	178	202	220	250	238
Total	267	319	354	373	351
Operating margin (%)					
BFSI	26.6	31.4	33.6	**31.8**	**28.4**
Non-BFSI	30.0	31.1	32.1	33.1	31.4
Total	28.8	31.2	32.7	32.7	30.4
Change in operating margin qoq (bps)					
BFSI		480	222	**(180)**	**(339)**
Non-BFSI		111	99	100	(167)
Total		244	144	1	(227)

Source: Company, Kotak Institutional Equities.

Infosys has sufficient buffers to offset upto 5% of offshore pricing decline in FY2010

Negatives (ex-pricing)	**Margin impact**
Wage inflation onsite (a)	(100)
Wage inflation offshore (a)	(200)
Rupee appreciation (b)	(50)
Total negative	**(350)**

Positives	**FY2009E**	**FY2010E best case**	**Change**		**Margin buffer**
Utilization rate (%) (c)	72.2	75.0	280	bps	110
SG&A (% of revenues)	13.4	13.0	40	bps	40
Employee pyramid (d)	57.0	59.0	2	%	60
Onsite offshore mix (e)	49.3	50.0	70	bps	30
Variable Comp					300
Subsidiay performance					75
Total positive					**615**
Margin buffer for pricing decline					**265**
Offshore pricing decline that can be accomodated (%)					**5**

Note:
(a) Assuming 3% average onsite and 10% average offshore wage hikes
(b) Assuming 1.2% Re appreciation in FY2010E
(c) Net utilization rate excluding support but including trainees; KIE estimates for FY2009E
(d) Denotes the # of employees in the 0-3 years experience band
(e) % revenues offshore

Source: Kotak Institutional Equities estimates.

FY2010 EPS and OPM at various level of changes in pricing for Infosys (without any volume offset)

EPS (Rs)

		Onsite pricing change (%)				
		(5)	(4)	(3)	(2)	(1)
Offshore pricing change (%)	(5)	104.0	104.7	105.5	106.2	107.0
	(4)	105.3	106.1	106.8	107.6	108.3
	(3)	106.6	107.4	108.1	108.9	109.6
	(2)	107.9	108.7	109.4	110.2	110.9
	(1)	109.2	110.0	110.7	111.5	112.2

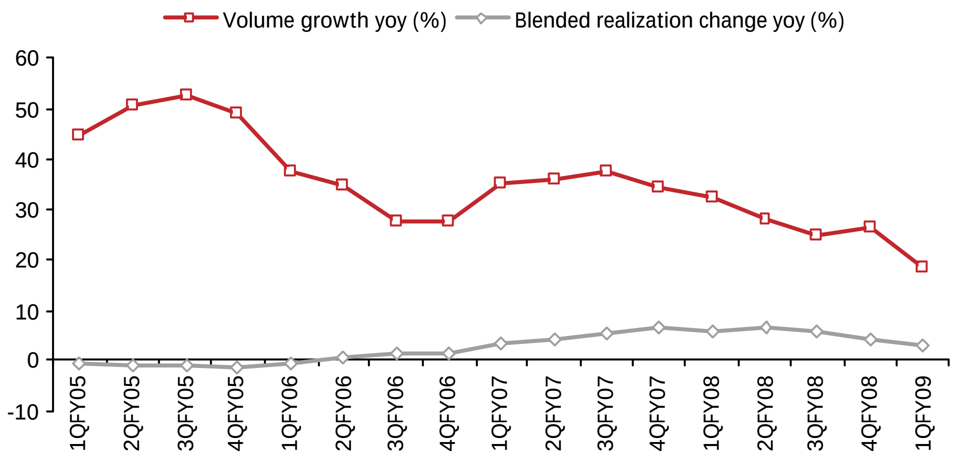
OPM (%)

		Onsite pricing change (%)				
		(5)	(4)	(3)	(2)	(1)
Offshore pricing change (%)	(5)	28.6	28.8	28.9	29.0	29.2
	(4)	28.8	29.0	29.1	29.2	29.3
	(3)	29.0	29.1	29.3	29.4	29.5
	(2)	29.2	29.3	29.4	29.6	29.7
	(1)	29.3	29.5	29.6	29.7	29.9

	FY2009	FY2010
Current estimates		
Base case EPS	102.1	118.1
Base case OPM (%)	31.4	30.8
Volume growth - onsite (%)	19.1	20.9
Volume growth - offshore (%)	20.2	20.6
Worst case scenario		
EPS		104.0
EPS - Change from base case (%)		(11.9)
EPS growth yoy (%)		1.9
OPM		28.6
OPM decline yoy worst case (bps)		(276)

Source: Kotak Institutional Equities estimates.

YoY volume growth of 18.6% in 1QFY09 the lowest in several years



Source: Company, Kotak Institutional Equities.

Infosys: FY2009E guidance revision and 1QFY09 performance versus actuals

FY2009E	Revised		Earlier		KIE estimates
	Lower end	Upper end	Lower end	Upper end	FY2009E
Revenues (US$ mn)	4,970.0	5,050.0	4,970	5,050	5,204
Growth yoy (%)	**19.0**	**21.0**	**19.0**	**21.0**	**24.6**
Revenues (Rs bn)	213	216	199	202	206
Growth yoy (%)	27.5	29.5	19.2	21.1	23.1
EPS (Rs)	98.8	100.5	92.3	93.9	87.8
Growth yoy (%)	24.4	26.6	16.3	18.3	11.0
EPADS (US$)	2.31	2.35	2.31	2.35	2.09
Growth yoy (%)	16.7	18.7	16.7	18.7	
Re/US$ rate	43.04		40.02		42.0

Source: Company, Kotak Institutional Equities estimates.

Comments Infosys interim results (consolidated Indian GAAP)

Rs mn	1QFY08	4QFY08	1QFY09	% chg. qoq	% chg. yoy	Deviation from Kotak estimates 4QFY08	Deviation from Kotak estimates % chg.	Comments
Revenues	**37,730**	**45,420**	**48,540**	**6.9**	**28.7**	**48,935**	**(0.8)**	Sequential revenue growth of 1.1% (US$ terms) marginally below our expectations and ahead of company's guidance of 0.3% qoq growth at the upper end. Volumes growth at 0.5% qoq and blended pricing improvement of 0.2% led to the revenue growth
Software Development Costs	(21,690)	(24,820)	(27,540)	11.0	27.0	(27,727)	**(0.7)**	Top client (BT) revenues down 22% qoq (absolte decline of US$26 mn, or 2.5% of revenues). Revenue growth from other clients was a robust 3.8%
Gross profit	**16,040**	**20,600**	**21,000**	**1.9**	**30.9**	**21,208**	**(1.0)**	
Selling and marketing exp	(2,050)	(2,230)	(2,570)	15.2	25.4	(2,746)	**(6.4)**	
Administration exp	(3,150)	(3,590)	(3,640)	1.4	15.6	(4,004)	**(9.1)**	
Total SG&A Expenses	(5,200)	(5,820)	(6,210)	6.7	19.4	(6,750)	**(8.0)**	
EBITDA	**10,840**	**14,780**	**14,790**	**0.1**	**36.4**	**14,458**	**2.3**	EBITDA margin decline of 200bps lower than our expectation of 300 bps qoq decline. Infosys continues to defy expectations on margin defence. Rupee was the key positive factor; SG&A investments also lower than expectations
Depreciation	(1,440)	(1,570)	(1,690)	7.6	17.4	(1,586)	**6.5**	
EBIT	9,400	13,210	13,100	(0.8)	39.4	12,872	**1.8**	
Interest	-	-	-			-		
Other Income	2,530	1,390	1,170	(16)	(53.8)	1,464	**(20.1)**	Includes forex losses of Rs800 mn versus our estimate of Rs400 mn
Provision for investments	-	-	-			-		
Profit Before Tax	11,930	14,600	14,270	(2.3)	19.6	14,336	**(0.5)**	
Provision for Tax	(1,650)	(2,310)	(1,560)	(32.5)	(5.5)	(2,081)	**(25.1)**	Effective tax rate of 11% in line lower than our expectation of 14.5%
Net Profit	**10,280**	**12,290**	**12,710**	**3.4**	**23.6**	**12,255**	**3.7**	
Minority Interest	-	-	-			-		
Extraordinaries	510	200	310			-		Tax reversal of Rs310 mn versus Rs200 mn during the Mar '08 quarter and Rs510 mn in the Jun '07 quarter
Net Profit- Reported	**10,790**	**12,490**	**13,020**	**4.2**	**20.7**	**12,255**	**6.2**	
EPS (Rs/ share)	17.9	21.4	22.1	3.4	23.6	21.3	**3.7**	
No of shares outstanding (mn)	574.0	574.0	574.0			574.0	**-**	
As % of revenues								
Gross Profit Margin (%)	42.5	45.4	43.3			43.3		
Operating Margin	28.7	32.5	30.5			29.5		
Selling Expenses	5.4	4.9	5.3			5.6		
Admin Expenses (%)	8.3	7.9	7.5			8.2		
SG&A Expenses (%)	13.8	12.8	12.8			13.8		
Billing Rates (US$/annum)								
Onsite	141,806	147,466	147,497	0.0	4.0			
Offshore	58,107	60,752	60,722	(0.0)	4.5			
Volumes growth	5.9	4.9	0.5			0.5		
Revenue Mix (%)								
Onsite	52.3	50.4	50.5					
Offshore	47.7	49.6	49.5					
Total Employees	75,971	91,187	94,379					1QFY09E gross hiring of 7,182. FY2009E gross hiring guidance stands at 25,000
Guidance (conslidated)	**2QFY09**			**FY2009**				
	Lower end	**Upper end**		**Lower end**	**Upper end**			
Revenues (Rs bn)	52.29	52.7		212.8	216.2			No change in US$ revenue growth guidance disappointing. Implied 3Q-4QFY09 sequential revenue growth CAGR of 5.9% reasonable in our view
Growth (%)	7.7	8.6		27.5	29.5			
Revenues (US$ mn)	1215	1225		4,970	5,050			
Growth (%)	5.2	6.1		19.0	21.0			
EPS (a)	23.52	23.95		98.8	100.5			FY2009E Re EPS guidance revision marginally ahead of expectations. Upward revision largely driven by Re/US$ rate reset
Growth (%)	5.9	7.9		24.4	26.6			

(a) FY2009E EPS guidance adjusted for Rs310 mn tax reversal

Guidance based on Re/ US$ rate of 40.02

Source: Company, Kotak Institutional Equities estimates.

Key changes to estimates, March fiscal year-ends, 2009E-2010E (Rs mn)

	New		Old		Change (%)	
	2009E	2010E	2009E	2010E	2009E	2010E
Revenues	**214,907**	**260,204**	**218,478**	**266,532**	**(1.6)**	**(2.4)**
EBITDA	67,499	80,122	68,570	82,169	(1.6)	(2.5)
Depreciation	(6,969)	(8,388)	(6,949)	(8,371)	0.3	0.2
EBIT	60,530	71,734	61,621	73,798	(1.8)	(2.8)
Net Profit	**58,593**	**67,781**	**58,999**	**68,626**	**(0.7)**	**(1.2)**
EPS (Rs/ share)	**102.1**	**118.1**	**102.8**	**119.6**	**(0.7)**	**(1.2)**
Revenues (US$ mn)	**5,117**	**6,271**	**5,204**	**6,425**	**(1.7)**	**(2.4)**
Volume Growth (%)	**19.9**	**20.7**	**22.7**	**22.0**		
Billing Rates (US$/ manmonth)						
Onsite	12,233	12,350	12,231	12,348	0.0	0.0
Offshore	5,036	5,084	5,038	5,087	(0.0)	(0.1)
Margins (%)						
EBITDA	31.4	30.8	31.4	30.8		
EBIT	28.2	27.6	28.2	27.7		
Rs/ US$ rate	42.0	41.5	42.0	41.5	0.0	0.0

Source: Kotak Institutional Equities Estimates.

Infosys Technologies: Consolidated Indian GAAP Income statement (Rs mn)

Rs mn	**2007**	**2008**	**2009E**	**2010E**	**2011E**
Revenues	**138,930**	**166,920**	**214,907**	**260,204**	**311,873**
Software Development Costs	(74,580)	(92,070)	(118,522)	(143,907)	(177,285)
Gross profit	**64,350**	**74,850**	**96,385**	**116,297**	**134,588**
Selling and marketing exp	(9,290)	(9,160)	(12,306)	(15,177)	(18,036)
Administration exp	(11,150)	(13,310)	(16,581)	(20,998)	(25,068)
Total SG&A Expenses	(20,440)	(22,470)	(28,887)	(36,175)	(43,103)
EBITDA	**43,910**	**52,380**	**67,499**	**80,122**	**91,485**
Depreciation	(5,140)	(5,980)	(6,969)	(8,388)	(10,217)
EBIT	**38,770**	**46,400**	**60,530**	**71,734**	**81,268**
Interest	-	-	-	-	-
Other Income	3,750	7,040	7,679	9,720	10,376
Profit Before Tax	**42,520**	**53,440**	**68,209**	**81,454**	**91,644**
Provision for Tax	(5,100)	(8,060)	(9,616)	(13,673)	(18,489)
Net Profit	**37,420**	**45,380**	**58,593**	**67,781**	**73,154**
Minority Interest	(110)	-	-	-	-
Net Income	**37,310**	**45,380**	**58,593**	**67,781**	**73,154**
Extraordinaries	1,250	1,210	310	-	-
Net Profit- Reported	**38,560**	**46,590**	**58,903**	**67,781**	**73,154**
EPS (Rs/ share)	**67.0**	**79.1**	**102.1**	**118.1**	**127.4**
No of shares outstanding (mn)	562.8	574.0	574.0	574.0	574.0
Margins (%)					
Gross Profit margin	46.3	44.8	44.8	44.7	43.2
EBITDA Margin	31.6	31.4	31.4	30.8	29.3
EBIT Margin	27.9	27.8	28.2	27.6	26.1
NPM	26.9	27.2	27.3	26.0	23.5
Growth Rates (%)					
Revenues	45.9	20.1	28.7	21.1	19.9
Gross Profit	44.4	16.3	28.8	20.7	15.7
EBITDA	42.0	19.3	28.9	18.7	14.2
EBIT	46.1	19.7	30.5	18.5	13.3
Net Profit	50.9	21.3	29.1	15.7	7.9
Net Income	51.8	21.6	29.1	15.7	7.9

Source: Kotak Institutional Equities estimates.

Technology

HCLT.BO, Rs239	
Rating	REDUCE
Sector coverage view	Neutral
Target Price (Rs)	300
52W High -Low (Rs)	342 - 180
Market Cap (Rs bn)	165.9

Financials

June y/e	2008	2009E	2010E
Sales (Rs bn)	75.7	97.1	117.0
Net Profit (Rs bn)	10.4	15.3	18.4
EPS (Rs)	14.9	22.1	26.4
EPS gth	*(20.9)*	*48.0*	*19.7*
P/E (x)	16.0	10.8	9.0
EV/EBITDA (x)	9.1	7.2	5.8
Div yield (%)	3.4	3.4	3.4

Shareholding, March 2008

	Pattern	% of Portfolio	Over/(under) weight
Promoters	67.4	-	-
FIIs	16.9	0.4	(0.1)
MFs	2.5	0.3	(0.1)
UTI	-	-	(0.4)
LIC	2.7	0.3	(0.2)

HCL Technologies: Unwinds huge forex forward positions; indicates forex losses of US$65-70 mn for Jun '08 quarter

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- **Indicates huge (US$65-75 mn) forex losses for June 2008 quarter**
- **FY2008E net income impacted; FY2009 earnings may get a boost**
- **Inconsistency in hedging policy as well as accounting treatment of hedges disappointing**
- **Maintain REDUCE rating**

HCL Technologies (HCLT) has announced it would book forex loss of US$65-75 mn in the June 2008 quarter, significantly higher than our expectations. The loss results from (1) unwinding of US$540 mn of forex covers—this led to US$9 mn of cash loss and US$30 mn reversal of MTM gains booked on these contracts in previous quarters, and (2) the rest US$26-36 mn accruing as a result of mark-to-market impact on the unassigned outstanding foreign exchange covers. The company has reduced its forex hedges outstanding to US$1.7 bn at end-June 2008 from US$2.5 bn as at end-March 2008. We are disappointed by the company's foreign exchange policy ('proactive' per company's release, a touch speculative in our view) as well the inconsistency in its forex hedge accounting policy—the company has changed its forex accounting policy twice in the past eight quarters. The cancellation of these contracts would depress FY2008E (HCLT has a June year end) earnings but will lead to significantly higher earnings for FY2009 as the company would now be able to book revenues at spot rates for the Sep '08 and Dec '08 quarters (the cancelled contracts pertain to these two quarters) as opposed to booking revenues at the underlying forward rates. We revise our FY2008E estimates to factor in the higher forex losses for the June 2008 quarter; we shall review our FY2009E and FY2010E estimates post June quarter results (likely in the first week of August). Maintain our REDUCE rating on the stock with a target price of Rs300/share; we shall review our target price post 4Q/FY2008 results.

Indicates huge (US$65-75 mn) forex losses for the June 2008 quarter. HCLT has announced it will report substantial losses on forex hedges (US$65-75 mn) for quarter ending June 30, 2008 (4QFY08 for the company) given (1) the sharp rupee appreciation (8.3%) during the quarter and (2) unwinding of US$540 mn of contracts. The losses include

1) US$9 mn cash loss on unwinding of US$540 mn of forward covers. The cancelled covers would have matured in the Sep '08 and Dec '08 quarters. We understand that the average rate of these contracts was 42 to a US$

2) US$30 mn reversal of MTM gains booked on US$540 mn cancelled contracts in the previous quarters; these contracts were taken before the Sep '07 quarter—HCLT used to follow mark to market method of forex hedge accounting prior to this period

3) US$26-36 mn MTM losses on unassigned outstanding hedges within the current US$1.7 bn of outstanding hedges. We understand that US$500 mn of the total outstanding hedges are currently unassigned

FY2008E net income impacted; FY2009 earnings may get a boost. Our FY2008E net income estimates reduce by 17.2%. to US$258 mn from US$300 mn earlier. Our net income forecast for June 2008 quarter reduces to US$24.7 mn (US$67 mn earlier) and FY2008E Re EPS reduces to Rs14.9 (Rs18 earlier). Note that HCLT has a June year-end. HCLT had forex gains of US$14.5 mn in the first nine months of FY2008. We would review our numbers for FY2009E post HCLT's June 2008 quarter results (likely in the first week of August). We highlight that the cancelled contracts pertain to the Sep '08 and Dec '08 quarters; the company would thus be able to book revenues at spot rates for these quarters as opposed to the underlying forward rate on the cancelled contracts (which we understand was Rs42). This would provide a boost to FY2009 net income, which otherwise would have been lower if the company had continued with previous hedges. The company also indicates that it has not cancelled any contracts pertaining to the periods after Dec '08; HCLT has around US$200 mn of forward covers each for Mar '09 and Jun '09 quarters at an average rate of Rs41.83 and Rs41.63, respectively.

Inconsistency in hedging policy as well as accounting treatment of hedges disappointing. We are disappointed with the inconsistency in HCLT's hedging policy as well as frequent changes in the accounting treatment of the forex hedges. We highlight some of our concerns below

- HCLT management had very recently (in the company's analyst meet in Sep, 2007) indicated to the investors that it had adopted a policy of hedging 8-10 quarters of net forex inflows. The company had substantially increased its forward covers to US$2 bn in the Sep '07 quarter from US$1.2 bn in the Jun '07 quarter. We find the unwinding of hedging positions (now that the aggressive hedging call is working against the company) inconsistent with the stated policy
- HCLT has changed its hedge accounting policy twice in the past eight quarters—(1) to mark to market accounting from cashflow hedge accounting in the June 2006 quarter; the company took an extraordinary charge of US$13.5 mn for the same and (2) back to cashflow accounting from MTM in the Sep 2007 quarter. We highlight that such frequent changes in accounting policy lead to (1) high volatility in earnings, (2) incomparable earnings across years, and (3) difficulty to draw comparisons with industry peers

June 2008 quarter results likely to be weak; FY2009E revenue growth guidance will also likely be modest: We estimate 4% revenue growth for HCLT in the June 2008 quarter—the company will just about achieve its FY2008E revenue growth guidance (US$ terms) of 35% (provided at the beginning of the fiscal). HCLT had indicated IT budget freeze from some of its top BFS accounts in its earnings commentary post March 2008 quarter. We do not expect a revival in revenues from these clients in the June 2008 quarter. Also, we highlight (once again) that HCLT continues to remain highly dependent on new client wins for revenue growth given its client mix (biased towards mid-sized companies outside F/G-1000). We expect HCLT's FY2009E revenue growth guidance to be in the range of 20-22%.

Pharmaceuticals

BION.BO, Rs397	
Rating	BUY
Sector coverage view	Attractive
Target Price (Rs)	700
52W High -Low (Rs)	664 - 330
Market Cap (Rs bn)	39.7

Financials

March y/e	2008	2009E	2010E
Sales (Rs bn)	10.5	17.8	22.4
Net Profit (Rs bn)	2.2	2.5	3.3
EPS (Rs)	22.4	24.6	32.8
EPS gth	*8.7*	*9.9*	*33.3*
P/E (x)	17.7	16	12.1
EV/EBITDA (x)	11.2	10.9	8.0
Div yield (%)	0.1	0.1	0.1

Shareholding, March 2008

	Pattern	% of Portfolio	Over/(under) weight
Promoters	60.9	-	-
FIIs	7.2	0.0	(0.1)
MFs	10.2	0.3	0.2
UTI	-	-	(0.1)
LIC	-	-	(0.1)

Biocon: FY2008 annual report update and focus on contract research

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- **EBITDA margin before R&D flat yoy at 30% due to increase in personnel and production costs**
- **Syngene reports lower PAT yoy at Rs331 mn due to rupee appreciation and higher employee costs**
- **Biocon plans significant capex in research business while Asian peers have overtaken it despite late start**
- **Biopharmaceuticals (38% of sales) surpasses statins while insulin alone accounts for 14% of sales**
- **Balance sheet quality improves due to lower debtor levels and cash from sale of enzymes business**
- **1Q FY2009 results due on July 17. KIE 1QFY09E revenues and PAT of Rs4.3 bn and Rs635 mn**
- **Maintain BUY rating with SOTP-based target price at Rs700**

EBITDA margins pre R&D for FY2008 remain flat yoy at 30% due to adverse currency movement and increase in staff costs. Syngene reports lower PAT margins at 21% in FY2008 vs. 38% in FY2007 as it increases manpower in order to service the BMS contract. Balance sheet quality improves due to lower debtor levels however inventory position worsens as Biocon ramps up its finished dosage business. The stock trades at 15X FY2009E and 12X FY2010E earnings. Maintain BUY rating with SOTP-based target price of Rs700.

EBITDA margin before R&D flat yoy at 30% due to increase in personnel and production costs. (1) Personnel costs increased 24% yoy to touch 14% of sales. Biocon increased total number of employees to 2,772 from 2,543—most in research business (2) production costs at 10% of sales increased 28% yoy due to increase in power and fuel costs.

Syngene reports lower PAT at Rs331 mn, down 33% yoy. Clinigene shows improvement in margins. Syngene profitability deteriorated significantly with PAT margins declining to 21% in FY2008 from 38% in FY2007 (see Exhibit 1). Syngene's expenses mainly comprise three categories: raw materials which consist of lab consumables; staff costs and other costs. (1) Staff costs and raw material costs increased around 40% yoy compared to yoy rupee sales growth of 22%. Syngene increased its headcount to 907 from 754 last year. This was to service the BMS contract which is an FTE-based contract and would start generating revenues in FY2009. Syngene has hired scientists from India and abroad to fulfill its commitments on the BMS deal. Biocon expects BMS contract to comprise 30% of Syngene revenues once the full capacity of 400 people are reached. (2) Other expenses apart from raw materials increased to 15% of sales in FY2008 from 9% of sales. Details of this expense category are not known. Currently, Syngene has 40 clients with top 10 contributing 70% of revenues.

Clinigene showed significant profitability improvement with PAT margins improving to 10% in FY2008 from 7% in FY2007 (see Exhibit 1). Clinigene's client list expanded to 20 besides Biocon during the year. Merck is its largest client. Headcount expanded to 150 in FY2008 from 70 in FY2007.

WuXi overtakes Syngene despite a late start. Biocon started Syngene in 1994 and Clinigene in 2000. Despite the early start, WuXi, started in 2000, has overtaken Syngene/Clinigene on almost all metrics (see Exhibit 2). WuXi has a headcount of 3,268 (including manufacturing) while Syngene/Clinigene reported total headcount of 1,057 as of March 2008.

During last year, WuXi has undertaken many steps to advance its offerings such as: (1) acquisition of Apptec, US-based provider of biologics research and development, and manufacturing services with revenues of US$70-72 mn in 2007. This acquisition adds to WuXi's biological research and manufacturing capabilities and creates an operational front-end in the US. (2) In June 2008, WuXi expanded its earlier relationship with Astrazeneca signing a three-year collaboration agreement. (3) Pfizer declared WuXi "chemistry CRO of the year" for 2007. Dr. Gonghua Pan of Pfizer, commented, "With WuXi's help, we reduced the average time from submitting the request to shipping of the finished product from 65 days in 2006 to 43 days in 2007, and at no increase in cost."

A key difference between the two is that WuXi offers manufacturing services (24% of revenues), a segment where Syngene has no presence. WuXi has guided towards doubling of revenues in 2008E at US$280-300 mn, whereas Biocon expects contract research revenues to grow 25% yoy. We expect Biocon's research business to grow 50% yoy to reach US$66 mn in FY2009E.

Significant capex planned in research business. Biocon was focused on growing its biopharmaceutical business in the past few years. It has now planned to invest Rs3 bn over the next 2-3 years in expanding capacities and manpower in its research businesses. In FY2009E, Syngene will see completion of (1) new research facility with chemical and biology research labs (2) construction of new pilot plant (3) biological pilot plant.

Currently, custom synthesis projects comprise 25% of revenues. Biocon expects this to increase to 50% in the next two years post the construction of the new kilo lab capacity. This would help Biocon improve EBITDA margins. Biocon also plans to scale up manpower in Clinigene by 40% in FY2009E and expand its pharmacology unit to 86 beds.

Statin sales at 37% of revenues (see Exhibit 3) remained flat for the year with volume growth compensating for lower pricing and weakening dollar. Simvastatin comprises around 80% of statin revenues for Biocon with the company enjoying market share of around 30% in this API worldwide. We forecast statin revenues to grow 5% yoy in dollar terms and estimate its share to drop to 23% of revenues in FY2009E.

Insulin revenues constitute 14% of sales currently. Biocon expects its insulin business to double over the next two years as it gains marketing approvals from overseas markets. During FY2008, Biocon entered into licensing agreements covering certain markets in Asia and has also made progress with its application for registering its insulin product in EU and RoW markets. It is aiming to register its insulin product in around 80 countries and expects 10-15 approvals to come in FY2009E.

Biocon commenced expansion of its insulin capacities which is to be commissioned in FY2009E clearly indicating increase in sales projections from its partners. It markets insulin under the brand name, Insugen, in India. Biocon expects to launch the insulin analogue, glargine in the next 12-18 months. We forecast insulin revenues of US$5 mn from China (JV with Bayer) in FY2009E and revenues of US$10 mn from developed markets in FY2010E. There could be an upside to our FY2010E estimate.

Immunosuppressant portfolio consists of Mycophenolate mofetil (MMF), sirolimus and tacrolimus. Tacrolimus revenues in USA have started since last quarter and Biocon expects revenues to ramp up significantly in FY2009E. There are several buyers of this API from Biocon. We forecast revenues from developed markets at US$10 mn in FY2009E rising to US$20 mn in FY2010E.

BIOMAB revenues at around Rs200 mn, 2% of FY2008 revenues. (1,000 patients X six weeks course costing Rs2.75 lakh). BIOMAB is currently approved in India for head and neck cancer. Phase II trials for expanding its indication to non small cell lung cancer is expected to be initiated in FY2009E. Within the next two years, the company plans to launch four other products — GCSF (oncology), Reteplase (cardiovascular), Streptokinase (cardiovascular) and insulin analogs. With two of the drugs already off patent, Biocon is actively pursuing distribution agreements for developed markets.

Biocon is also looking at setting up a tablet finished dosage manufacturing unit. Currently, it manufactures its own injectible finished dosage across entire bio-pharma range in which it operates but is getting the oral finished dosage done on a contract basis. Biocon has presence in tablet dosage form in nephrology, diabetology, cardiology and oncology segment. This segment accounts for about 10% of revenues and it expects to reach Rs 1 bn of revenue in the next four years.

Balance sheet quality improves due to lower debtor levels. As seen in exhibit 4, Biocon reported improvement in NWC (% of sales) to 39% in FY2008 from 42% in FY2007. The improvement in NWC position is due to lower debtor levels. However the company's inventory position worsened during the year. We expect this to continue as the company expands its formulations business internationally. Biocon is sitting on cash of Rs2 bn after selling enzymes business to Novozyme.

KIE 1QFY09E revenues and PAT of Rs4.3 bn and Rs635 mn. Yoy and qoq comparisons are not meaningful due to the addition of Axicorp revenues this quarter and presence of enzymes business last year. We expect total revenues at Rs4.3 bn, with revenues ex Axicorp growing 20% qoq. We expect EBITDA margins before R&D at 23%, down qoq due to the addition of low margin Axicorp business.

R&D update. Biocon with a view to achieve greater focus on its research is proposing to set up a new R&D entity for discovery and innovative drug development initiatives. We believe the spin-off may be in preparation of licensing deals for its two NCE molecules in phase II (IN0105 for diabetes and T1h for Psoriasis/Rheumatoid arthritis). The management believes licensing deals are likely in 2009 as important proof of concept studies may completed by that time (see Exhibit 5).

Maintain BUY rating with SOTP-based target price of Rs700. We continue to use SOTP method for valuation. There is no material change in our earnings estimates for FY2009E and FY2010E.

Subsidiaries- headline numbers (Rs mn)

	FY2006	FY2007	FY2008
Syngene			
Revenues	966	1,316	1,604
EBITDA	527	584	517
% margin	55	44	32
PBT	484	512	355
PAT	452	497	332
% margin	47	38	21
Clinigene			
Revenues	57	116	227
PBT	(11)	8	24
PAT	(11)	8	24
% margin	(20)	7	10

Source: Company.

Comparison with WuXi (US$ mn)

	Syngene/Clinigene	WuXi
Revenues	44	135
PBT	9	35
% margins	21	26
PAT	8	34
% margins	19	25
Total no. of customers	60	80
Headcount	1,057	3,268

Source: Company.

Revenue breakup (% of sales)

	FY2007	FY2008	FY2009E	FY2010E
Pharmaceuticals	**72**	**75**	**83**	**80**
Statins	40	37	23	19
Others	32	38	34	38
Axicorp			26	22
Enzymes	11	5		
Contract research	14	17	15	18
License fees	3	4	2	2

Source: Company.

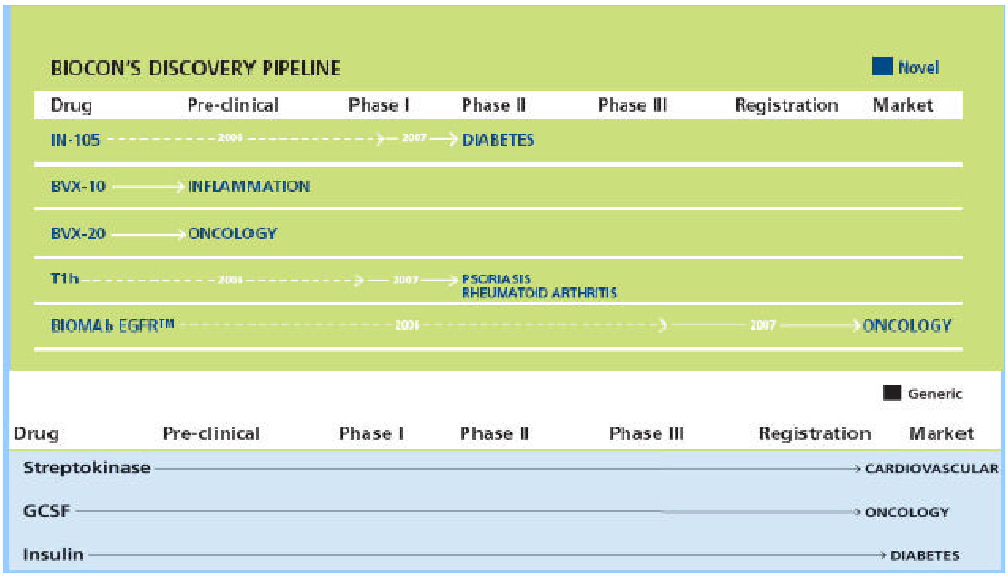
Net working capital (% of net sales)

	FY2005	FY2006	FY2007	FY2008
Biocon*	22	33	42	39
Dishman	64	53	62	
Divis	52	54	39	
Jubilant	14	22	22	
Piramal*	18	15	20	17

* Actuals for FY2008

Source: Company.

Research pipeline



Source: Company.

Economy

Sector coverage view N/A

Low growth and high inflation unlikely to take feet off monetary brakes

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- **IIP at 3.8% in May, 6.2% in April reaffirms growth is slowing down**
- **Headline inflation surges to 11.89%, likely to hit 14% by September 2008**
- **Liquidity has tightened, but may ease again in August**
- **RBI likely to persist with tightening bias but choice of instruments complicated**

IIP and inflation numbers released on July 11, 2008 are unlikely to put RBI off its current policy stance of tightening bias. It has raised CRR by 125 bps to 8.75% and repo rate by 75 bps to 8.5% in 1QFY09 and is now seeing a strong transmission of its earlier action. However, with still higher inflation expected ahead and still no signs of credit growth slowing down, we expect the central bank to use its scheduled policy date of July 29 to continue with tightening. However, the choice of monetary instrument for the objective has got complicated.

The three I's of July 11—Infosys results, inflation data and IIP numbers disappointed the street. Sensex felt 456 points (-3.3%) and nifty by 113 points (-2.7%). We believe neither of the news fundamentally alters the course of the economy, which in our assessment may hit a low this quarter and starts improving from there. We look at the IIP and inflation data releases and what they might mean for the policy choices.

IIP growth slowing down, but we expect IIP to grow at over 8% in June

IIP growth at 3.8% in May 2008 was disappointing (see Exhibit 1). Street consensus was at 6.7%. It is important to interpret the IIP data over months. Our view has all along been that IIP growth is decelerating. We are not yet revising our industrial growth forecast from 7.6% for FY2009E, though the growth in the first two months is at 5%. We expect IIP growth to rebound to over 8% in June on positive base effects and anecdotal evidence that output levels in June were better than in May.

Drop in capital goods growth at 2.5% magnified by the base effects

- We believe drop in growth in capital goods production to 2.5% yoy has been magnified by base effects. Capital goods production in May 2008 was 10.7% higher than in April 2008 (see Exhibit 2).
- On the other hand, consumer goods growth at 7.2% yoy has been pushed up by the base effects. Its output actually fell by 2% in May 2008 from the preceding month, due mainly to non-durable consumption goods. Consumer durables output was 10.2% higher in May than in April.
- The slowdown is clearly evident on both yoy basis and mom basis in case of basic goods and intermediate goods production.

On a 4mMA basis IIP growth has dropped to below 6% for the first time since June 2003 (see Exhibit 3). The large downward revision of April 2008 IIP growth to 6.2% from 7% earlier also added to the slowdown assessment.

Price increases this week cover primary and manufactured products

Inflation for the week-ended June 28, 2008 surged to 11.89% from This weeks' price increase was mainly in fruits and vegetables (2.4%), fibres (4.0%), oilseeds (1.9%), edible oils (1.8%), textiles (2.5%), fertilizers (4.2%), cement (1.1%). Inflation rate for manufacturing products is now in double-digits for the second consecutive week (see Exhibit 4).

Prices increased across several manufacturing commodities in recent weeks

Looking at the price data, RBI may be concerned about the nature of price rise in the recent weeks. Price pressures have been building up in recent weeks across certain manufacturing products. While part of this may be due to cost push, the central bank may also be seized of the possibility of its demand pull nature. Strong price pressures have been visible in the following cases:

- Textiles prices increased for fifth straight week rising by 8% during this period
- Manufactured food prices increased for seventh straight week, but the rise was lower at 3.7% during this period
- Prices of 'chemicals and chemical products' have risen for the ninth consecutive week, with a rise of 5.1% over this period
- Prices of 'machine and machine tools' has risen for the 11th consecutive week, but with an increase of only 2.5% during these weeks
- Prices of 'leather and leather products' have increased by 2.4% in two of the last five weeks, but remained stable this week

RBI likely to retain tightening bias in its policy

We believe considering the risks of further increase in inflation rate due to demand side pressures and the strong credit growth, RBI is likely to continue to tighten monetary policy further. It may like to see non-food credit growth slowing down from 26.6% yoy (as on June 20, 2008) to about 22% by October.

Liquidity presently tight, but may ease in August

Liquidity conditions are presently fairly tight, but may ease ahead in August if: (1) GOI pays Rs250 bn to banks (mainly co-operative banks) for the farm debt relief, (2) increases social spending after trust vote in the run-up to elections and (3) capital inflows renew on the back of more attractive stock valuations after price correction.

In our assessment, currently the banking system as a whole has been kept short of daily liquidity by about Rs250 bn on a fortnightly average basis. LAF injections have crossed Rs400 bn over last two working days, but they are more reflective of the product basis of reserve maintenance on a fortnightly average basis.

Second part of the CRR hike to 8.75% would kick in only from the fortnight starting July 19. This is likely to ensure that there would be no monetary easing in near term.

Choice of monetary policy instruments complicated

We believe the choice of monetary policy instrument has become complicated in view of uncertainty about the timing of future government spending and capital flows along with the lower growth and higher inflation numbers.

If it is clear that GOI would release Rs250 bn of farm debt relief compensation to the banking system by mid-August, the central bank is likely to depend more on CRR to immediately mop up the resultant primary liquidity which would be generated. If, however, the release is deferred and no lumpy capital inflows occur, RBI is likely to depend more on the repo rate to signal retention of tightening. We, therefore, expect the following;

- RBI may raise CRR by 50 bps to 9.25% and repo rate by 25 bps to 9% if it is clear that liquidity conditions are set to ease in August say by Rs250 bn is being infused by farm debt relief to banks
- RBI may raise repo rate by 50 bps to 9.25% leaving CRR unchanged if it sees no change in present tight liquidity conditions in near term

As such, developments during the ensuing week may be critical in RBI's policy decision. In either case, RBI would be staying ahead of the curve, as it has been for the past year. However, if growth considerations get a greater weight and policy action is milder, it could be a positive surprise for the markets.

Exhibit 1: May 2008 IIP growth disppointing

Sectoral classification for IIP, March fiscal year-ends, 2007-2008 (%)

	Mining (%)			Manufacturing (%)			Electricity (%)			General (%)		
	2007	2008	2009	2007	2008	2009	2007	2008	2009	2007	2008	2009
Weights (%)		**10.5**			**79.4**			**10.2**			**100.0**	
April	3.4	2.6	6.0	11.0	12.4	6.7	5.9	8.7	1.4	9.9	11.3	6.2
May	2.9	3.8	5.2	13.3	11.3	3.9	5.0	9.4	2.0	11.7	10.6	3.8
June	4.7	1.5		10.8	9.7		4.9	6.8		9.7	8.9	
July	5.1	3.2		14.3	8.8		8.9	7.5		13.2	8.3	
August	(1.7)	14.7		11.9	10.8		4.1	9.2		10.3	10.9	
September	4.3	4.9		12.7	7.4		11.3	4.5		12.0	7.0	
October	5.9	5.2		3.8	13.8		9.7	4.2		4.5	12.2	
November	8.8	6.4		17.2	4.7		8.7	5.8		15.8	4.9	
December	6.1	5.0		14.5	8.6		9.1	3.8		13.4	8.0	
January	7.7	2.9		12.3	6.7		8.3	3.7		11.6	6.2	
February	7.5	7.9		12.0	9.6		3.3	9.8		11.0	9.5	
March	8.0	4.9		16.0	3.9		7.9	3.7		14.8	3.9	
April-March	**5.4**	**5.1**		**12.5**	**8.8**		**7.3**	**6.4**		**11.5**	**8.3**	

Source: CSO, Government of India.

Exhibit 2: Industrial slowdown spread across various use-based sectors

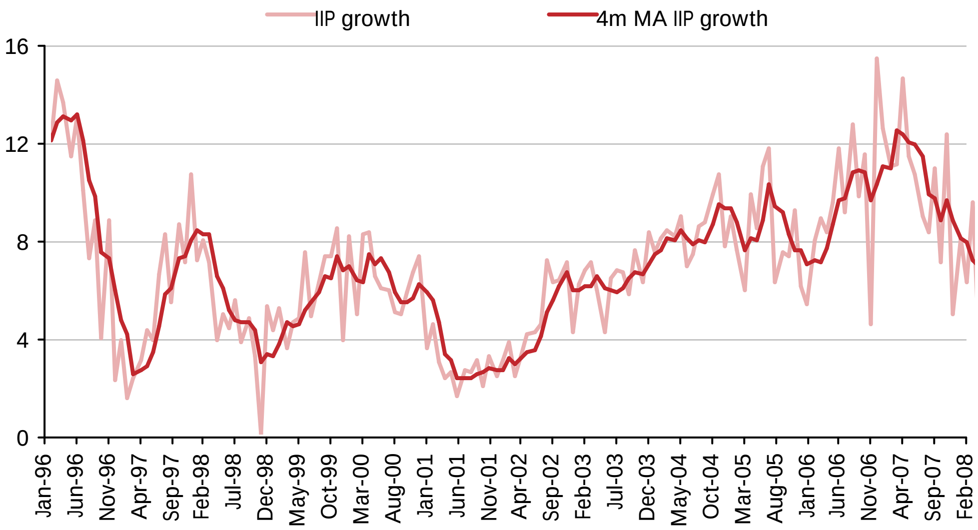
Use-based classification for IIP, March fiscal year-ends, 2007-2008 (%)

	Basic goods			Capital goods			Intermediate goods			Consumer goods			Consumer durables			Consumer non-durables		
	2007	2008	2009	2007	2008	2009	2007	2008	2009	2007	2008	2009	2007	2008	2009	2007	2008	2009
Weights (%)		**35.57**			**9.26**			**26.51**			**28.66**			**5.37**			**23.30**	
April	9.3	8.6	4.0	19.6	10.9	11.4	8.5	10.6	3.3	8.9	14.7	8.6	7.4	2.4	5.4	9.4	18.7	9.5
May	9.2	10.3	3.0	21.5	22.4	2.5	12.5	8.8	1.3	10.5	8.7	7.2	17.5	(0.7)	4.4	8.2	12.2	8.1
June	8.5	9.2		21.7	23.1		11.3	8.7		6.1	3.6		19.9	(3.6)		1.8	6.3	
July	10.0	8.7		18.3	12.3		10.7	7.7		16.8	7.1		16.2	(2.7)		17.1	10.6	
August	4.8	12.8		16.6	30.8		8.7	13.8		15.0	(0.0)		19.0	(6.2)		13.6	2.4	
September	11.5	6.5		9.5	20.9		13.8	10.2		12.1	(0.2)		11.8	(7.3)		12.2	2.6	
October	10.5	6.5		6.5	20.9		5.9	13.9		(2.8)	13.7		0.2	9.0		(4.1)	15.8	
November	12.1	5.2		29.4	24.2		17.9	5.5		13.5	(2.9)		10.1	(5.5)		14.8	(2.0)	
December	12.4	3.4		26.2	17.6		12.7	7.6		10.7	8.7		1.8	2.8		13.5	10.3	
January	12.0	3.6		16.3	2.6		13.7	8.0		8.2	8.4		5.3	(0.5)		9.1	11.1	
February	10.7	7.4		18.0	10.7		13.3	8.5		7.4	11.7		1.8	3.1		9.3	14.3	
March	11.9	3.4		18.1	11.0		15.3	4.3		15.8	0.9		3.8	(1.8)		20.2	1.8	
April-March	**10.3**	**7.0**		**18.2**	**16.9**		**12.0**	**8.9**		**10.1**	**6.1**		**9.2**	**(1.0)**		**10.4**	**8.5**	

Source: CSO, Government of India.

Exhibit 3: IIP growth decelerates since March 2007

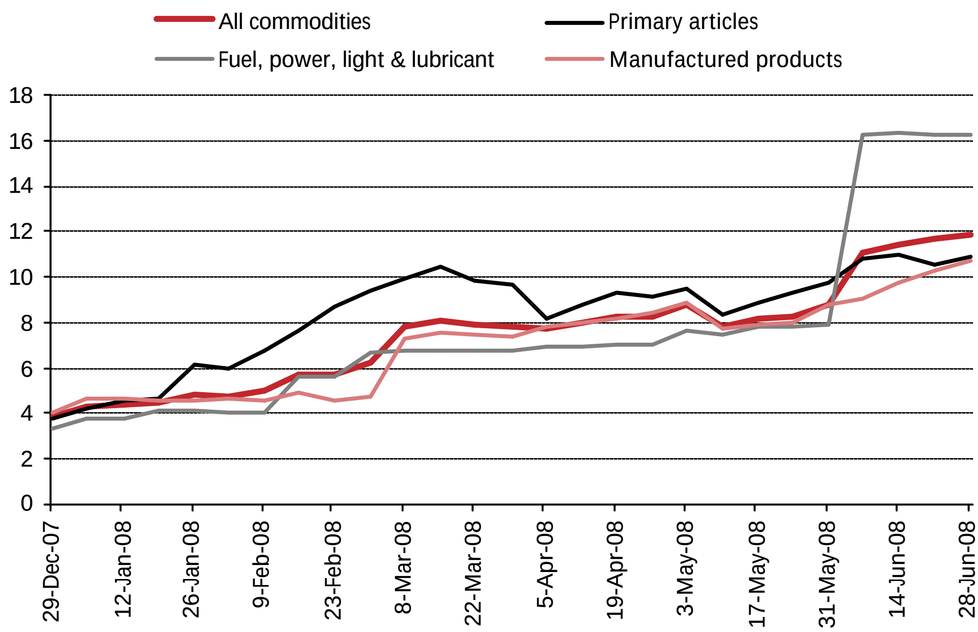
yoy growth in IIP and its 4-month moving average (%), April 1995-April 2008



Source: CSO, Government of India.

Exhibit 4: Manufacturing inflation also now in double-digits

WPI inflation rate for major groups (yoy %)



Source: Office of the Economic Advisor, Ministry of Commerce & Industry, Government of India

Telecom

		Price, Rs	
Company	Rating	11-Jul	Target
Bharti	REDUCE	745	840
Rcom	SELL	438	550
MTNL	ADD	92	120
VSNL	REDUCE	382	430
Idea Cellular	REDUCE	84	110

June GSM net adds—mobile subs continue to soar

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- **Strong net adds continue; GSM net adds (ex-RCL) at 6.3 mn, total net adds will likely exceed 8.5 mn again**
- **Another month of market share gains for Bharti, Idea—at the expense of BSNL, yet again**
- **Expect strong revenue growth for wireless players on the back of strong net adds; key areas to watch would be the trend in RPM and minutes elasticity**

GSM operators (excluding RCOM) added 6.3 mn subs in June 2008, same as May 2008 and broadly in line with our expectations. We expect the recent trends viz. strong monthly subs net adds, market share gains for strong/aggressive incumbents like Bharti, Vodafone-Essar, and Idea and rapid market share decline for BSNL/MTNL to continue for the next few months till new competition enters the market. We do highlight though that it has taken a series of price cuts and aggressive network expansion by the telecom operators to sustain the current net adds trajectory (the last break-out in monthly net adds trajectory was in March 2007, the month of Rs499 lifetime plan introduction). We once again emphasize that these pricing cuts and impending competition will put pressure on the RPM/EPM/profitability levels of these companies—June 2008 quarter operational metrics will provide early cues on the impact of recent pricing cuts on ARPU/MOU/RPM/EPM etc. Pricing risk underscores our Cautious coverage view on the sector. We however see limited downside to Bharti (REDUCE, TP: Rs840) post the recent sharp correction in the stock price.

June GSM net adds in line with expectations. The aggregate GSM (ex-RCOM) net adds for June 2008 (6.32 mn) was in line with our expectations and moderately higher than May 2008 net adds of 6.28 mn. Overall net adds for the months could exceed 8.5 mn if the CDMA operators maintain their May 2008 net adds pace. We expect the strong net adds trend to continue over the next 12-18 months driven by (1) rapid network expansion by the existing players, (2) entry of new players and pan-Indian expansion of some incumbents and (3) aggressive pricing tactics adopted by the operators. However, we do not see substantial value accretion for the industry from these incremental subscribers. A large proportion (>35%) of net adds are coming in as lifetime subscribers—we estimate an NPV of US$80-90/sub for a lifetime subscriber (see Exhibit 1) as opposed to an EV of US$300-400 per sub implied in the current valuations of Indian wireless stocks.

Robust net adds to ensure strong revenue growth for the June 2008 quarter for private operators; however, RPM and MOU trends would be the key. Bharti (7.4 mn net adds in June 2008 quarter, 11.9% qoq growth) and Idea (3.2 mn, 13.3%) will likely report strong revenue growth for the June 2008 quarter on the back of strong net adds. We estimate 9.4% and 10.6% qoq wireless revenue growth for June 2008 quarter for Bharti and Idea respectively. However, we see RPM, MOU, and EPM trend as the key operational metrics to watch out for in the quarterly results. We saw substantial reduction in STD/roaming tariffs during the quarter (end-April 2008) in addition to the continuous introduction of new tariff plans (recharge vouchers) with aggressive local calling rates.

Bharti Airtel—continues to surpass expectations. Bharti had another strong month adding 2.56 mn subscribers in June 2008, 0.1 mn higher than the May 2008 net adds of 2.46 mn. More importantly, Bharti's share of GSM net adds, assuming RCL maintains its May '08 net adds, improved to 38.3%, the company's highest ever and a sharp 320 bps higher than Bharti's previous six month's average GSM net adds share. We expect Bharti to continue gaining market share till the entry of new players and pan-India expansion of existing players like Vodafone, Idea, and Aircel. We highlight the upside risk to our end-March 2009 subscriber assumptions for Bharti; our current assumptions imply a monthly net add run rate of 1.72 mn from July '08 to Mar '09.

Vodafone-Essar—keeping Bharti honest. Vodafone-Essar continues to remain the closest competitor to Bharti; the company added 1.73 mn subs in the month of Jun '08, its highest ever and implying a GSM net add market share of 25.9% for the month. We note that Vodafone-Essar is expanding into a pan-India player over the next couple of quarters (it is currently present in 16 of 23 circles) and we believe the company can give Bharti a serious run for its money upon expanding into a pan-India player.

Idea Cellular—solid net adds, but Spice net adds disappoint. Idea Cellular added 1.05 mn subs, marginally lower than previous month's 1.1 mn subs. More importantly though, Spice's (Idea recently announced Spice acquisition) net adds for the month were a disappointing 50,000, its lowest since Sep '06.

BSNL—no revival in fortunes, as yet. BSNL reported subs net adds of 365,000 for the month of June 2008, marginally higher than the 314,000 net adds it reported in May 2008. More importantly, the company continues to be constrained for capacity and there are no signs of an improvement in the situation any time soon.

Others—Aircel disappoints, so does MTNL. Aircel added 433,000 subs in June 2008, lower than May net adds of 503,000. MTNL added 87,000 subs (versus 67,000 in May 2008); we note that MTNL's GSM net adds for the June 2008 quarter of 196,000 subs is substantially lower than the 287,000 net adds in the March 2008 quarter and will likely impact MTNL's wireless revenue growth for the quarter.

No significant value-accretion from lifelong subscribers, in our view

NPV of a Rs199 lifetime sub																
Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
Revenues	1,200	1,320	1,440	1,584	1,742	1,830	1,921	2,017	2,118	2,224	2,335	2,452	2,574	2,703	2,838	2,980
Monthly ARPU	100	110	120	132	145	152	160	168	176	185	195	204	215	225	237	248
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	658	721	749	785	823	863	905	772	807	843	881	921	964
Initial capex (Rs)	(2,765)															
Initial capex (US$)	(70)															
Maintenance capex									(55)	(55)	(55)	(55)	(55)	(55)	(55)	(277)
Change in working capital	177															
Free cash flow	(2,083)	553	601	658	721	749	785	823	808	849	717	751	788	826	866	687
Terminal growth rate (%)	0	5														
WACC (%)	12.5	12.5														
NPV (Rs)	**3,097**	**3,654**														
NPV (US$)	**78**	**92**														

Source: Kotak Institutional Equities estimates.

Subscriber details for leading GSM cellular operators, ('000)

	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
Subs ('000)													
Bharti	42,704	44,763	46,815	48,876	50,909	52,961	55,163	57,418	59,670	61,985	64,370	66,826	69,384
Vodafone Essar	30,752	32,437	34,115	35,658	37,187	38,563	39,865	41,145	42,557	44,126	45,780	47,467	49,195
IDEA Cellular	16,126	17,004	17,871	18,672	19,422	20,222	21,054	21,955	22,874	24,002	25,040	26,141	27,194
BPL	1,088	1,095	1,102	1,153	1,201	1,221	1,239	1,257	1,276	1,295	1,314	1,331	1,378
Spice Communications	3,170	3,290	3,398	3,482	3,570	3,661	3,801	3,943	4,084	4,211	4,363	4,498	4,548
Reliance	4,139	4,439	4,734	5,036	5,342	5,669	6,002	6,338	6,676	7,016	7,359	7,711	7,711
MTNL	2,609	2,669	2,729	2,772	2,826	2,890	2,955	3,013	3,122	3,242	3,284	3,350	3,438
BSNL	28,423	28,979	29,704	30,303	31,033	31,945	32,712	33,749	34,573	36,210	36,683	36,997	37,363
Aircel	6,775	7,162	7,621	8,039	8,524	9,026	9,428	9,934	10,185	10,610	10,989	11,492	11,925
Total market	**135,787**	**141,839**	**148,089**	**153,991**	**160,014**	**166,157**	**172,219**	**178,751**	**185,017**	**192,696**	**199,182**	**205,813**	**212,135**
Market share of subs (%)													
Bharti	31.4	31.6	31.6	31.7	31.8	31.9	32.0	32.1	32.3	32.2	32.3	32.5	32.7
Vodafone Essar	22.6	22.9	23.0	23.2	23.2	23.2	23.1	23.0	23.0	22.9	23.0	23.1	23.2
IDEA Cellular	11.9	12.0	12.1	12.1	12.1	12.2	12.2	12.3	12.4	12.5	12.6	12.7	12.8
BPL	0.8	0.8	0.7	0.7	0.8	0.7	0.7	0.7	0.7	0.7	0.7	0.6	0.6
Spice Communications	2.3	2.3	2.3	2.3	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.1
Reliance	3.0	3.1	3.2	3.3	3.3	3.4	3.5	3.5	3.6	3.6	3.7	3.7	3.6
MTNL	1.9	1.9	1.8	1.8	1.8	1.7	1.7	1.7	1.7	1.7	1.6	1.6	1.6
BSNL	20.9	20.4	20.1	19.7	19.4	19.2	19.0	18.9	18.7	18.8	18.4	18.0	17.6
Aircel	5.0	5.0	5.1	5.2	5.3	5.4	5.5	5.6	5.5	5.5	5.5	5.6	5.6
Growth (%)													
Bharti	4.8	4.8	4.6	4.4	4.2	4.0	4.2	4.1	3.9	3.9	3.8	3.8	3.8
Vodafone Essar	5.3	5.5	5.2	4.5	4.3	3.7	3.4	3.2	3.4	3.7	3.7	3.7	3.6
IDEA Cellular	5.6	5.4	5.1	4.5	4.0	4.1	4.1	4.3	4.2	4.9	4.3	4.4	4.0
BPL	0.5	0.6	0.7	4.7	4.2	1.6	1.5	1.4	1.6	1.5	1.5	1.3	3.5
Spice Communications	5.4	3.8	3.3	2.5	2.5	2.6	3.8	3.7	3.6	3.1	3.6	3.1	1.1
Reliance	7.1	7.2	6.7	6.4	6.1	6.1	5.9	5.6	5.3	5.1	4.9	4.8	-
MTNL	2.4	2.3	2.3	1.6	1.9	2.3	2.3	2.0	3.6	3.8	1.3	2.0	2.6
BSNL	1.5	2.0	2.5	2.0	2.4	2.9	2.4	3.2	2.4	4.7	1.3	0.9	1.0
Aircel	5.7	5.7	6.4	5.5	6.0	5.9	4.5	5.4	2.5	4.2	3.6	4.6	3.8
Total market	**4.4**	**4.5**	**4.4**	**4.0**	**3.9**	**3.8**	**3.6**	**3.8**	**3.5**	**4.2**	**3.4**	**3.3**	**3.1**
Net monthly adds ('000)													
Bharti	1,960	2,059	2,051	2,061	2,033	2,053	2,202	2,255	2,253	2,315	2,386	2,456	2,558
Vodafone Essar	1,542	1,686	1,678	1,542	1,529	1,376	1,302	1,281	1,412	1,569	1,654	1,686	1,728
IDEA Cellular	860	878	867	801	750	800	832	901	919	1,128	1,038	1,101	1,054
BPL	6	7	7	51	48	19	19	17	20	19	19	17	47
Spice Communications	163	120	107	84	89	91	139	142	141	126	152	135	50
Reliance	275	300	296	302	306	327	333	336	338	340	342	352	-
MTNL	61	60	60	43	54	64	65	58	109	120	42	67	87
BSNL	429	556	725	599	730	912	767	1,036	824	1,637	473	314	365
Aircel	366	387	458	419	485	502	402	506	251	425	379	503	433
Total market	**5,662**	**6,052**	**6,250**	**5,903**	**6,022**	**6,144**	**6,062**	**6,531**	**6,266**	**7,680**	**6,486**	**6,630**	**6,323**
Market share of net adds (%)													
Bharti	34.6	34.0	32.8	34.9	33.8	33.4	36.3	34.5	35.9	30.1	36.8	37.0	40.5
Vodafone Essar	27.2	27.9	26.8	26.1	25.4	22.4	21.5	19.6	22.5	20.4	25.5	25.4	27.3
IDEA Cellular	15.2	14.5	13.9	13.6	12.5	13.0	13.7	13.8	14.7	14.7	16.0	16.6	16.7
BPL	0.1	0.1	0.1	0.9	0.8	0.3	0.3	0.3	0.3	0.2	0.3	0.3	0.7
Spice Communications	2.9	2.0	1.7	1.4	1.5	1.5	2.3	2.2	2.3	1.6	2.4	2.0	0.8
Reliance	4.9	4.9	4.7	5.1	5.1	5.3	5.5	5.1	5.4	4.4	5.3	5.3	-
MTNL	1.1	1.0	1.0	0.7	0.9	1.0	1.1	0.9	1.7	1.6	0.6	1.0	1.4
BSNL	7.6	9.2	11.6	10.1	12.1	14.8	12.7	15.9	13.2	21.3	7.3	4.7	5.8
Aircel	6.5	6.4	7.3	7.1	8.0	8.2	6.6	7.7	4.0	5.5	5.8	7.6	6.8
Circlewise subs ('000)													
Metros	23,499	24,297	25,066	25,884	26,691	27,460	28,135	28,823	29,510	30,235	30,903	31,555	32,199
Circle A	48,139	50,430	52,996	55,247	57,719	60,089	62,479	65,033	67,081	70,045	72,090	74,344	76,837
Circle B	49,201	51,587	53,867	56,089	58,259	60,498	62,582	64,870	67,289	70,077	72,920	75,636	78,120
Circle C	14,948	15,525	16,160	16,771	17,345	18,111	19,024	20,024	21,137	22,339	23,269	24,277	24,980
Total	**135,787**	**141,839**	**148,089**	**153,991**	**160,014**	**166,157**	**172,219**	**178,751**	**185,017**	**192,696**	**199,182**	**205,813**	**212,135**
Circlewise net adds ('000)													
Metros	715	798	769	817	807	770	675	689	687	725	667	652	644
Circle A	1,886	2,292	2,566	2,252	2,471	2,370	2,391	2,554	2,048	2,964	2,045	2,254	2,492
Circle B	2,408	2,385	2,280	2,222	2,170	2,239	2,083	2,289	2,418	2,788	2,843	2,716	2,484
Circle C	653	577	635	611	574	765	913	1,001	1,113	1,202	930	1,008	703
Total	**5,662**	**6,052**	**6,250**	**5,903**	**6,022**	**6,144**	**6,062**	**6,531**	**6,266**	**7,680**	**6,486**	**6,630**	**6,323**
Circlewise subs (%)													
Metros	17	17	17	17	17	17	16	16	16	16	16	15	15
Circle A	35	36	36	36	36	36	36	36	36	36	36	36	36
Circle B	36	36	36	36	36	36	36	36	36	36	37	37	37
Circle C	11	11	11	11	11	11	11	11	11	12	12	12	12
Circlewise net adds (%)													
Metros	13	13	12	14	13	13	11	11	11	9	10	10	10
Circle A	33	38	41	38	41	39	39	39	33	39	32	34	39
Circle B	43	39	36	38	36	36	34	35	39	36	44	41	39
Circle C	12	10	10	10	10	12	15	15	18	16	14	15	11

Note:
(a) Subscriber numbers for June 2008 exclude RCOM GSM subs (not disclosed yet)

Source: Cellular Operator's Association of India, Compiled by Kotak Institutional Equities.

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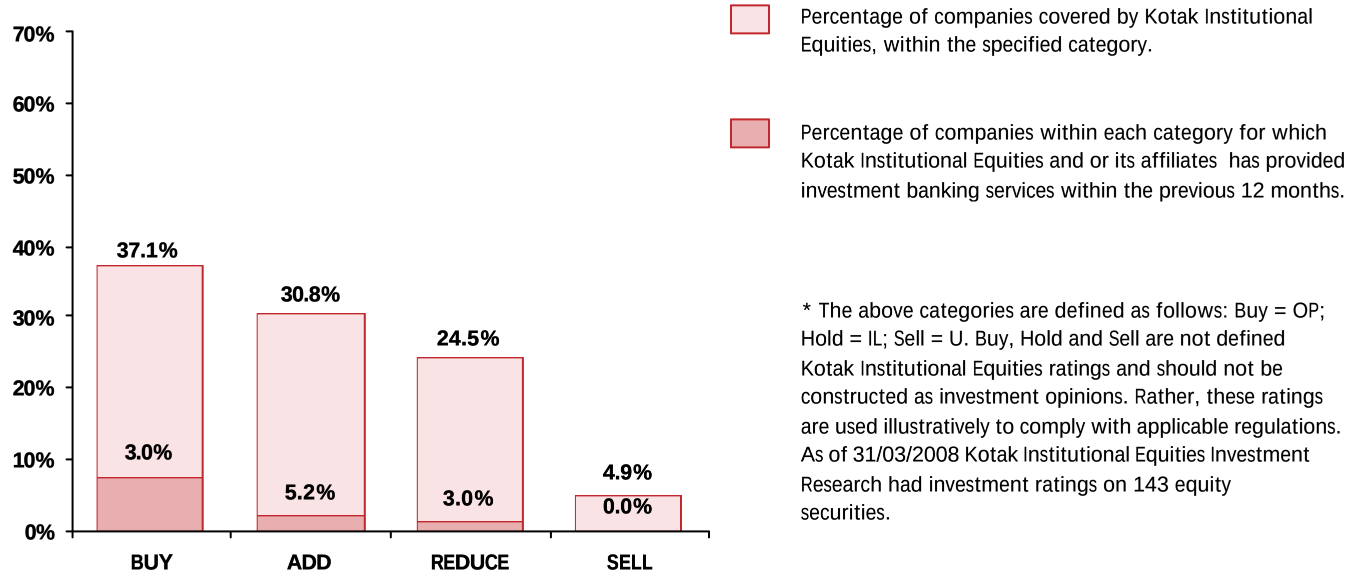

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Source: Kotak Institutional Equities. As of March 31, 2008

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

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