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Strategy: 1QFY09 results review—quite decent under the circumstances

Results

Federal Bank: PAT exceeds estimates, maintain BUY given attractive valuation

News Roundup

Corporate

- The country's biggest power utility firm **NTPC** has readied a US\$ 3bn war chest for global buyouts. The company is learnt to be in negotiations to buy at least one coal mine in Indonesia and taking a long lease on another. (ET)
- **Tata Motors** is understood to be in talks with a Norway-based company **Miljobil Grenland** to develop an electric car. (ET)
- Global media baron **Rupert Murdoch** plans to buy 20-26% in the **Sakaal Group's** upcoming Marathi news channel Saam TV, slated for an August -15 launch. (BS)
- National Multi-Commodity Exchange (**NMCE**) is looking for a foreign partner. The exchange, in which Reliance Money picked up a 26% stake recently, is ready to concede a minimum 5% stake to a foreign partner. (FE)
- In one of the larger deals in the BPO space in India, **Aegis BPO**, a part of the over US\$50 bn **Essar Group**, has signed an agreement to acquire the Los Angeles-based **PeopleSupportInc** in an all-cash deal valued at US\$250 mn. (FE)
- **General Atlantic LLC (GA)**, a leading US PE firm, could pick up a minority stake in **Wockhardt Hospitals Ltd**, the healthcare entity of drug major Wockhardt. The deal size is learnt to be in the range of US\$80-100 mn for a 20% stake. (FE)
- **Reliance Communications** is set to float a US\$500 mn tender for GSM 3G networks. At present, RCOM is predominantly a CDMA-based operator. (ET)

Economic and political

- The Centre is considering a proposal to bring iron ore under price control in an attempt to check steel prices. (ET)
- The government may defer the implementation of the sixth Pay Commission award by a year or even two to reduce the fiscal burden of the recommendations that proposed a 28% across-the-board salary increase for an estimated 4.5 mn central government employees. (BS)

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

EQUITY MARKETS

India	Change, %			
	4-Aug	1-day	1-mo	3-mo
Sensex	14,578	(0.5)	8.4	(17.2)
Nifty	4,395	(0.4)	9.4	(15.9)
Global/Regional indices				
Dow Jones	11,326	(0.5)	0.3	(13.3)
FTSE	5,363	0.2	(0.9)	(13.7)
Nikkei	12,933	(1.2)	(2.3)	(7.9)
Hang Seng	22,515	(1.5)	5.1	(14.2)
KOSPI	1,543	(2.0)	(2.2)	(16.5)
Value traded - India				
	Moving avg, Rs bn			
	4-Aug	1-mo	3-mo	
Cash (NSE+BSE)	194.2	182.1	184.6	
Derivatives (NSE)	487.8	479.7	340	
Deri. open interest	598.1	633	640	

Forex/money market

	Change, basis points			
	4-Aug	1-day	1-mo	3-mo
Rs/US\$	42.5	7	(69)	178
6mo fwd prem, %	0.7	(25)	71	24

Net investment (US\$m)

	1-Aug	MTD	CYTD
Fls	(85)	-	(6,746)
MFs	44	-	2,679

Top movers -3mo basis

Best performers	Change, %			
	4-Aug	1-day	1-mo	3-mo
UNITED PHOSPHOR	352	0.5	33.4	11.2
RANBAXY LABORA	523	2.5	(2.9)	8.4
CIPLA LTD	220	(0.0)	5.7	3.3
SIEMENS INDIA LIM	582	1.1	35.7	0.6
SUN PHARMACEUTI	1,440	(0.3)	8.9	0.2
Worst performers				
UNITECH LIMITED	169	(0.4)	1.4	(47.0)
INDIABULLS REAL E	303	4.0	8.3	(46.5)
INFRASTRUCTURE D	99	1.2	(7.7)	(45.4)
INDIABULLS FINANC	295	(0.2)	20.5	(45.4)
HOUSING DEVELOP	478	4.3	15.9	(43.5)

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Strategy

Sector coverage view

N/A

1QFY09 results review—decent in the circumstances

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- **Reported 1QFY09 PAT for BSE-30 stocks grew 16.6% versus our expected 6.3%**
- **Banking, industrials, pharma and ONGC contributed to the positive surprise**
- **We model 15.1% earnings growth for FY2009E and 11.6% on an ex-energy basis**

1QFY09's reported PAT for BSE-30 stocks grew 16.6% yoy driven by strong and better-than-expected performance from banking, industrials, pharma and ONGC. 1QFY09 results give us more confidence in our projected 15.1% PAT growth for FY2009E. However, we note that our projected PAT growth has declined from 18.4% at the beginning of 2008 and 19.1% at the beginning of 1QFY09. However, ex-energy PAT growth at 10.1% was below our full year's 11.6%, which puts additional onus on the rest of the year. We retain our end-CY2008 BSE-30 Index target of 16,000 (mid-point of 14,000-18,000 range).

One quarter down reasonably well, three to go. 1QFY09's PAT growth of 16.6% will likely provide the street with some confidence for FY2009E earnings. We model 15.1% PAT growth for FY2009E and 22.5% for FY2010E. We note that 1QFY09 growth is down significantly from 33.8% in 1QFY08 but in line with 4QFY08's 16.4%. The steep decline in PAT yoy growth reflects a sharp compression in EBITDA margins, which in turn, reflects a steep yoy increase in input costs and disproportionately lower growth in prices. EBITDA margin declined by 190 bps yoy to 15.3% (for KIE coverage stocks) due to a decline EBITDA margin in most sectors as can be seen in Exhibit 4.

EBITDA margins in pharma and technology expanded modestly, reflecting lower SG&A expenses and the positive impact of a modestly weaker rupee, respectively. However, we would clarify that the steep increase in prices in certain sectors would have also contributed to EBITDA margins declining in percentage terms. It may not make much sense to look at EBITDA margins in percentage terms in cyclical businesses such as energy and metals; profitability in those sectors is more important.

Difference in performance versus peers. We highlight stocks for which 1QFY08 performance was different versus those of its peers.

- 1. Automobiles—Hero Honda.** Hero Honda reported an expansion in EBITDA margin (yoy) unlike other automobile majors due to its ability to grow volumes (+11.4% yoy), raise prices (+4.3% yoy increase in average realization) and absorb increases in input costs.
- 2. Cement—India Cements and UltraTech Cement.** 1QFY09 EBITDA margins of India Cements and of UltraTech Cement declined by 200 bps only compared to about 700 bps for other cement stocks under our coverage. Both managed through control of costs by increased blending of fly ash with cement (India Cements) and lower freight costs (UltraTech).
- 3. Energy—Reliance Industries (RIL).** RIL reported refining margins of US\$15.7/bbl including inventory gain of US\$1.7/bbl, which is well below that of its peers—Chennai Petroleum Corp. (US\$9/bbl out of reported refining margin of US\$15.9/bbl) and Mangalore Petrochemicals and Refineries (US\$11.3/bbl out of reported refining margin of US\$18/bbl). We would assume a US\$27/bbl increase in crude prices over the period (end-February to end-May) would have resulted in inventory gains of the order of US\$9-11/bbl based on a typical refining cycle of 30-40 days (from the time of purchase of a barrel of crude to sale of products corresponding to the same barrel of crude).

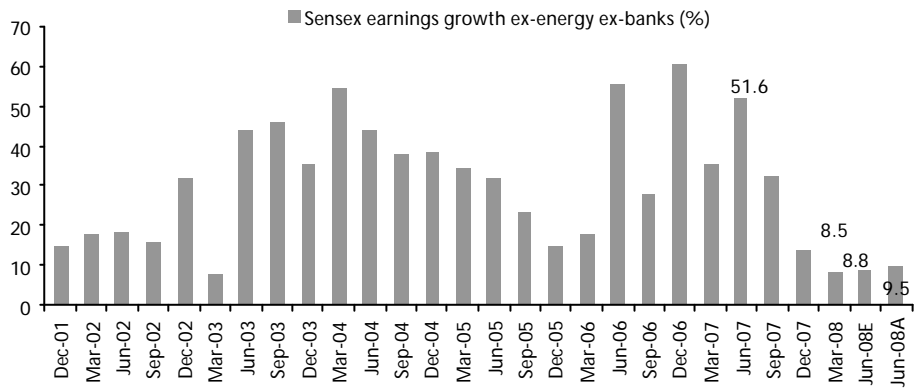
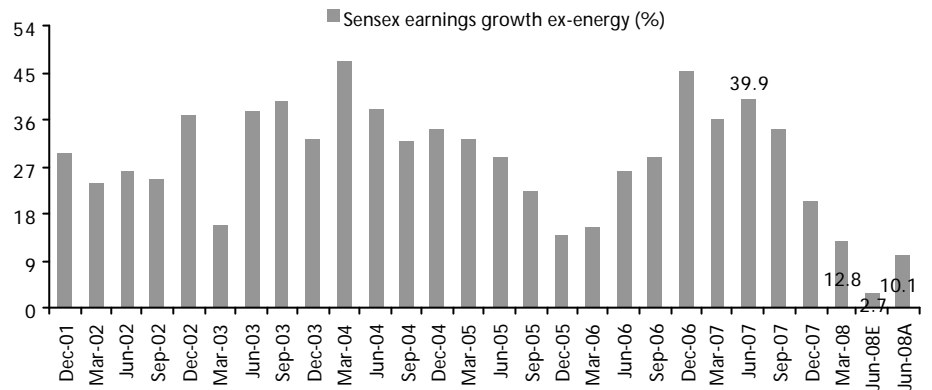
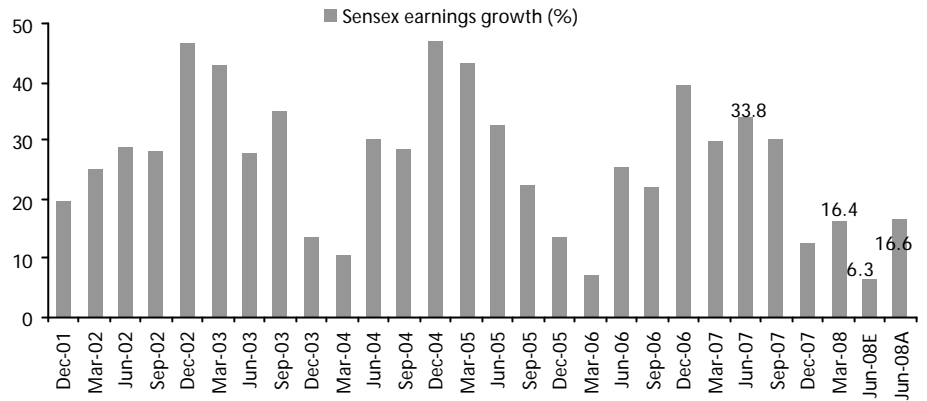
4. **Technology—TCS.** TCS reported a yoy decline in EBITDA margin (85 bps) in contrast to other large technology companies, which reported a 30-180 bps increase in EBITDA margins. Exhibit 5 compares the top five players on certain operating and financial parameters for the past few quarters.
5. **Telecom—Reliance Communications (RCOM).** Reliance Communications' 1QFY09 wireless revenues declined 1% qoq in contrast to 8% qoq growth for Bharti Airtel and 10.2% qoq growth for Idea Cellular. This was primarily led by a decline in MOU; RCOM's MOU declined 1.4% qoq to 424 versus growth of 5.3% (to 534) for Bharti and of 4.1% (to 428) for Idea. Exhibit 6 compares the financial and operating parameters of RCOM's wireless segment with those of Bharti and Idea for the past few quarters.

Changes in accounting policies and other notable issues on disclosures, corporate governance in 1QFY09

1. **Dish TV.** Dish TV has changed its accounting policy for the cost of its set-top box and upfront amount under the new scheme. Dish TV now books a large part of the deposit received from the subscriber as subscription revenues over 12 months and the remaining as rental income over five years. Dish previously used to book the deposit received from the subscriber over five years as rental income for the STB.
2. **Reliance Communications.** RCOM changed its accounting policy related to gains or losses on foreign currency borrowings arising from fluctuations in exchange rate. It has adjusted the impact (Rs10.6 bn loss) in foreign currency borrowings arising from foreign exchange fluctuations to the carrying cost fixed of assets. In FY2008, it had routed the impact through the P&L as per accounting standard 11 (AS 11). It had a gain of Rs8.7 bn in FY2008 on this account due to appreciation of the rupee excluding the impact on FCCBs. Before FY2008, RCOM used to adjust any income or expense on account of exchange difference either on settlement or on translation in the profit and loss account, except in cases where they relate to acquisition of fixed assets in which case they are adjusted to the carrying cost of such assets. RCOM has thus adopted the accounting treatment that it followed until FY2007 once gain from 1QFY09.
3. **Sobha Developers.** Sobha has changed its accounting policy for revenue recognition for sale of undivided share of land (group housing) on the basis of 20% collection of dues. Thus, Sobha now recognizes the full cost of the land (plus margins) for the sold portion once the collection reaches 20%. This will likely lead to faster booking of revenues as revenues corresponding to land sales will get recognized faster. The earlier policy was to recognize revenues on a project reaching a significant level of completion.
4. **TCS.** TCS has changed its accounting policy on computers and increased the useful life to four years from two years. This resulted in lower depreciation charge of Rs497 mn (positive impact of 67 bps on EBIT).

Changes in ratings post 1QFY09 results. Exhibit 7 shows the changes to ratings of stocks under our coverage after 1QFY09/2QCY08 results. We had eight upgrades (barring BUY from ADD or REDUCE from SELL) versus seven downgrades (barring SELL from REDUCE or ADD from BUY).

1QFY09 growth is down significantly from 33.8% in 1QFY08 but in line with 4QFY08's 16.4%
Trend in quarterly earnings of BSE-30 Index



Note:

(1) We have assumed actual reported numbers to be same as our estimate numbers for metals sector.

Source: Company, Kotak Institutional Equities estimates.

Banks, industrials, pharmaceuticals and ONGC did better than expectations

Reported PAT of BSE-30 Index stocks versus expectations, 1QFY09/2QCY08 (Rs mn)

	Industry	Jun-07	Mar-08	June-08A	June-08E	A versus E	Growth (%)	
						(%)	Yoy	Qoq
Tata Motors	Automobiles	4,648	4,006	3,616	4,096	(11.7)	(22.2)	(9.7)
Mahindra & Mahindra	Automobiles	1,928	2,072	2,372	2,414	(1.7)	23.1	14.5
Maruti Suzuki	Automobiles	4,996	2,977	4,659	4,390	6.1	(6.8)	56.5
State Bank of India	Banking	14,258	18,833	16,408	5,923	177.0	15.1	(12.9)
ICICI Bank	Banking	7,751	11,498	7,280	4,702	54.8	(6.1)	(36.7)
HDFC Bank	Banking	3,212	4,711	4,644	3,840	20.9	44.6	(1.4)
HDFC	Banking	3,728	7,681	4,681	5,069	(7.7)	25.6	(39.1)
Grasim Industries	Cement	5,117	4,414	5,142	3,683	39.6	0.5	16.5
ACC	Cement	3,458	3,210	2,591	2,943	(11.9)	(25.1)	(19.3)
Ambuja Cements	Cement	3,746	3,318	3,120	3,225	(3.2)	(16.7)	(6.0)
Hindustan Unilever	Consumers	4,719	3,810	5,401	5,451	(0.9)	14.5	41.8
ITC	Consumers	7,829	7,356	7,487	8,517	(12.1)	(4.4)	1.8
Oil & Natural Gas Corporation	Energy	46,105	49,751	65,929	51,609	27.7	43.0	32.5
Reliance Industries	Energy	34,600	39,130	41,100	43,081	(4.6)	18.8	5.0
Bharat Heavy Electricals	Industrials	6,877	3,844	3,844	3,817	0.7	(44.1)	—
Larsen & Toubro	Industrials	2,894	10,511	5,024	4,096	22.7	73.6	(52.2)
Hindalco Industries	Metals	6,029	5,363	6,968	6,968	—	15.6	29.9
Tata Steel	Metals	12,221	12,061	14,884	14,884	—	21.8	23.4
Jaiprakash Associates	Others	1,400	2,097	1,273	1,950	(34.8)	(9.1)	(39.3)
Cipla	Pharmaceuticals	1,129	1,572	2,013	1,359	48.1	78.2	28.0
Ranbaxy Laboratories	Pharmaceuticals	1,085	1,291	1,743	1,427	22.2	60.7	35.0
DLF	Property	15,231	22,067	18,948	18,939	0.0	24.4	(14.1)
TCS	Technology	11,855	12,559	12,436	12,636	(1.6)	4.9	(1.0)
Wipro	Technology	7,104	8,754	8,846	8,934	(1.0)	24.5	1.1
Infosys Technologies	Technology	10,280	12,290	12,711	12,256	3.7	23.6	3.4
Satyam Computer Services	Technology	3,783	4,669	5,477	5,286	3.6	44.8	17.3
Bharti Airtel	Telecom	15,115	18,529	20,250	19,609	3.3	34.0	9.3
Reliance Communications	Telecom	12,193	15,032	15,124	14,844	1.9	24.0	0.6
Reliance Infrastructure	Utilities	2,216	3,114	4,395	1,830	140.2	98.3	41.1
NTPC	Utilities	23,699	13,395	17,265	20,875	(17.3)	(27.1)	28.9
BSE-30 Index		279,206	309,916	325,631	298,653	9.0	16.6	5.1
BSE-30 Index (ex-energy)		198,500	221,035	218,602	203,963	7.2	10.1	(1.1)
BSE-30 Index (ex-energy, banks)		169,551	178,312	185,589	184,429	0.6	9.5	4.1

Note:

- (1) We have assumed actual reported numbers to be same as our estimate numbers for metals sector.
(2) HDFC Bank's yoy and qoq PAT growth comparison distorted by CBOP merger.

Source: Kotak Institutional Equities estimates

Banking sector's 1QFY09 net income outperformed most versus expectations

Performance of sectors versus expectations (KIE universe) in 1QFY09/2QCY08

Revenues: Sectors posting positive surprises

	Companies (#)	Net sales (Rs mn)		Change (%)
		Actual	Expected	
1 Construction	4	48,111	41,252	16.6
2 Banking	24	199,896	181,459	10.2
3 Consumers	9	116,345	110,152	5.6
4 Consumer (Discretionary)	3	16,552	16,052	3.1
5 Transportation	4	44,886	44,182	1.6

Revenues: Sectors posting negative surprises

	Companies (#)	Net sales (Rs mn)		Change (%)
		Actual	Expected	
18 Energy	10	2,323,232	2,668,646	(12.9)
17 Others	8	55,134	60,414	(8.7)
16 Pharmaceuticals	10	82,741	88,065	(6.0)
15 Property	8	60,144	62,537	(3.8)
14 Telecom	5	179,639	186,774	(3.8)

Operating profits: Sectors posting positive surprises

	Companies (#)	Operating profits (Rs mn)		Change (%)
		Actual	Expected	
1 Consumer (Discretionary)	3	3,012	2,719	10.8
2 Construction	4	4,155	3,839	8.2
3 Cement	6	25,945	24,550	5.7
4 Technology	11	59,745	58,013	3.0
5 Media	5	3,678	3,661	0.5

Operating profits: Sectors posting negative surprises

	Companies (#)	Operating profits (Rs mn)		Change (%)
		Actual	Expected	
17 Transportation	4	4,114	8,696	(52.7)
16 Utilities	5	32,155	38,376	(16.2)
15 Others	8	10,776	12,753	(15.5)
14 Retail	3	2,163	2,528	(14.4)
13 Automobiles	5	20,240	23,154	(12.6)

PAT: Sectors posting positive surprises

	Companies (#)	Net sales (Rs mn)		Change (%)
		Actual	Expected	
1 Banking	24	68,650	46,853	46.5
2 Media	5	1,664	1,394	19.4
3 Consumer (Discretionary)	3	1,465	1,250	17.2
4 Cement	6	16,447	15,384	6.9
5 Construction	4	1,936	1,813	6.8

PAT: Sectors posting negative surprises

	Companies (#)	Net sales (Rs mn)		Change (%)
		Actual	Expected	
18 Transportation	4	(235)	419	(156.2)
17 Others	8	4,691	6,473	(27.5)
16 Retail	3	992	1,140	(12.9)
15 Consumers	9	17,196	18,585	(7.5)
14 Utilities	5	25,362	26,093	(2.8)

Source: Kotak Institutional Equities estimates

EBITDA margins came off in 1QFY09

Comparison of EBITDA margin for KIE universe stocks (%)

	Jun-07	Mar-08	Jun-08
Automobiles	12.9	10.3	10.1
Banking	—	—	—
Cement	33.4	28.6	29.0
Construction	9.4	10.1	8.6
Consumer (Discretionary)	20.9	15.0	18.2
Consumers	22.4	18.5	19.3
Energy	11.3	8.9	9.9
Industrials	11.1	13.7	10.7
Media	29.2	25.1	25.2
Metals	37.0	35.7	37.8
Others	18.0	19.6	19.5
Pharmaceuticals	20.0	26.1	24.1
Property	63.3	59.3	60.0
Retail	5.1	6.0	4.6
Technology	23.0	23.7	23.5
Telecom	37.9	38.6	38.1
Transportation	24.0	20.8	9.2
Utilities	24.1	22.6	20.8
KIE universe	17.2	15.6	15.3
BSE-30 Index	10.2	9.7	7.9

Source: Kotak Institutional Equities estimates

Comparison of operating and financial parameters of technology companies, 1QFY08-1QFY09

	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
Revenues (US\$ mn)					
Infosys	928	1,022	1,084	1,142	1,156
TCS	1,268	1,392	1,492	1,517	1,525
Wipro	779	858	979	1,032	1,068
Satyam	449	505	557	607	617
HCLT	396	429	461	485	504
Revenue growth qoq (%)					
Infosys		10.1	6.1	5.4	1.2
TCS		9.8	7.2	1.7	0.5
Wipro		10.1	14.2	5.4	3.5
Satyam		12.4	10.4	9.0	1.7
HCLT		8.4	7.5	5.2	3.9
EBITDA margin - consolidated (%)					
Infosys	28.7	31.3	32.6	32.5	30.5
TCS	24.8	25.7	26.1	25.0	24.0
Wipro	19.4	20.1	20.1	20.6	20.5
Satyam	22.4	19.8	21.5	22.8	24.1
HCLT	20.6	20.2	20.4	21.3	22.5
Volume growth (IT services) qoq (%)					
Infosys	5.9	8.4	4.5	4.9	0.8
TCS	7.6	8.2	5.3	4.8	1.3
Wipro		7.7	6.4	5.7	2.2
Satyam	11.8	8.6	10.0	9.2	1.9
HCLT	6.5	9.0	7.3	5.3	4.0
Pricing change qoq (%)					
Infosys	1.0	1.9	0.8	0.2	0.2
TCS	0.6	0.9	0.5	(1.6)	(0.9)
Wipro	(0.0)	1.6	(0.0)	(0.1)	2.9
Satyam	0.3	2.9	0.9	0.1	(0.0)
HCLT	1.1	0.4	0.9	1.1	0.0
Net hiring					
Infosys	3,730	4,530	8,100	2,586	3,192
TCS	5,512	9,268	4,037	3,299	4,895
Wipro	2,719	4,463	2,389	1,919	(499)
Satyam	2,716	3,037	3,424	1,122	651
HCLT	1,868	3,625	2,312	1,848	939
Days sales outstanding (#)					
Infosys	93	98	95	100	105
TCS	67	66	66	75	75
Wipro	68	63	61	66	66
Satyam	90	92	89	90	93
HCLT	69	77	72	77	79.0

Note:

(a) Net hiring for IT services only for Satyam.

(b) Offshore pricing change for Wipro.

Source: Companies, Kotak Institutional Equities estimates.

Comparison of operating and financial parameters of Indian wireless players, 2QFY07-1QFY09

	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
Wireless gross revenues (Rs mn)								
Bharti	33,022	37,579	42,431	46,976	50,579	56,105	64,201	69,150
Growth qoq (%)		13.8	12.9	10.7	7.7	10.9	14.4	7.7
RCOM	25,744	27,520	29,692	33,730	37,230	39,567	41,608	41,187
Growth qoq (%)		6.9	7.9	13.6	10.4	6.3	5.2	(1.0)
Idea	10,096	11,482	13,084	14,773	15,622	17,081	19,724	21,735
Growth qoq (%)		13.7	14.0	12.9	5.7	9.3	15.5	10.2
Wireless EBITDA (Rs mn)								
Bharti	12,179	14,129	16,604	19,087	20,728	22,887	22,779	21,218
RCOM	9,294	10,290	11,511	13,392	14,870	15,819	16,763	16,623
Idea	3,548	3,712	4,360	5,128	5,106	5,672	6,621	7,158
Wireless EBITDA margin (%)								
Bharti (a)	36.9	37.6	39.1	40.6	41.0	40.8	35.5	30.7
RCOM	36.1	37.4	38.8	39.7	39.9	40.0	40.3	40.4
Idea	35.1	32.3	33.3	34.7	32.7	33.2	33.6	32.9
Wireless subs ('000)								
Bharti	27,061	31,974	37,141	42,704	48,876	55,163	61,985	69,384
RCOM	25,979	29,980	28,968	31,879	36,324	40,964	45,793	50,773
Idea	10,363	12,442	14,011	16,126	18,672	21,054	24,002	27,194
Minutes of use (min/sub/month)								
Bharti	451	467	475	478	469	474	507	534
RCOM	461	454	541	510	490	449	430	424
Idea	344	369	387	381	360	377	411	428
ARPU (Rs/sub/month)								
Bharti	438	427	406	390	366	358	357	350
RCOM	354	328	377	375	361	339	317	282
Idea	335	322	317	320	288	279	287	278
RPM (Rs/min)								
Bharti	0.97	0.91	0.85	0.82	0.78	0.76	0.70	0.66
RCOM	0.77	0.72	0.70	0.74	0.74	0.76	0.74	0.66
Idea	0.97	0.87	0.82	0.84	0.80	0.74	0.70	0.65
Total minutes (mn)								
Bharti	33,844	41,305	49,240	57,125	64,375	73,840	89,058	105,217
RCOM	33,520	38,100	42,500	45,800	50,700	52,500	56,500	62,000
Idea	9,736	12,629	15,469	17,100	18,831	22,457	27,824	33,087

Note:

(a) Impacted by rental payments to the passive infra division starting Mar 2008 quarter.

Source: Companies, Kotak Institutional Equities.

Major changes in ratings after the results announcement

		New	Old
Upgrades			
AIA Engineering	Upgraded	BUY	REDUCE
Canara Bank	Upgraded	REDUCE	SELL
Castrol India	Upgraded	ADD	REDUCE
Consolidated Construction Co.	Upgraded	BUY	ADD
Container Corporation	Upgraded	ADD	REDUCE
Educomp Solutions	Upgraded	ADD	REDUCE
GAIL (India)	Upgraded	BUY	ADD
Gateway Distriparks	Upgraded	BUY	REDUCE
GE Shipping	Upgraded	BUY	ADD
Grasim Industries	Upgraded	ADD	REDUCE
Lanco Infratech	Upgraded	BUY	ADD
LIC Housing Finance	Upgraded	ADD	REDUCE
Petronet LNG	Upgraded	ADD	SELL
Phoenix Mills	Upgraded	BUY	ADD
Sesa Goa	Upgraded	BUY	ADD
Sintex	Upgraded	BUY	ADD
Sun TV Network	Upgraded	REDUCE	SELL
Tech Mahindra	Upgraded	BUY	ADD
Downgrades			
Aban Offshore	Downgraded	REDUCE	ADD
Hindustan unilever	Downgraded	REDUCE	ADD
IDFC	Downgraded	REDUCE	ADD
Mahindra & Mahindra Financial	Downgraded	SELL	REDUCE
Maruti Suzuki	Downgraded	ADD	BUY
NTPC	Downgraded	REDUCE	ADD
Puravankara Projects	Downgraded	REDUCE	ADD
Reliance Petroleum	Downgraded	REDUCE	ADD
Sobha	Downgraded	REDUCE	ADD

Source: Kotak Institutional Equities estimates

Valuation summary of BSE-30 sectors

	Adj mkt cap.		EPS growth (%)			PER (X)			EV/EBITDA (X)			Price/BV (X)			Div. yield (%)		RoE (%)		
	Mkt cap. (US\$ mn)	cap. (US\$ mn)	2008	2009E	2010E	2008	2009E	2010E	2008	2009E	2010E	2008	2009E	2010E	2008	2009E	2008	2009E	2010E
Automobiles	12,427	7,708	5.8	(8.2)	0.5	11.2	12.2	12.1	7.5	7.7	7.4	2.4	1.5	1.4	1.9	2.1	21.3	12.5	11.3
Banking	66,602	49,622	43.9	(7.6)	31.1	18.9	20.5	15.6	—	—	—	2.5	2.3	2.0	1.3	1.2	13.3	11.1	12.6
Cement	6,534	4,515	25.7	(7.9)	(11.7)	7.3	7.9	8.9	4.0	4.2	4.3	1.7	1.4	1.3	2.6	2.7	23.7	18.2	14.2
Consumers	28,577	17,591	12.2	13.3	14.6	25.4	22.4	19.5	17.9	14.2	12.2	8.6	7.6	6.6	3.0	2.7	33.8	33.9	34.0
Diversified	4,321	2,593	20.7	54.7	53.5	30.1	19.5	12.7	14.8	11.0	10.2	3.7	3.2	2.6	0.0	0.0	12.2	16.3	20.6
Energy	121,570	45,686	12.9	24.3	39.1	15.1	12.2	8.7	7.3	5.9	4.2	2.7	2.2	1.9	1.6	1.9	17.7	17.8	21.3
Industrials	39,069	24,017	23.7	36.9	28.8	32.6	23.8	18.5	18.8	13.5	10.5	7.3	5.3	4.2	0.7	0.8	22.3	22.3	22.8
Metals	23,752	15,376	(2.7)	14.2	(1.4)	8.9	7.8	7.9	4.9	4.4	4.3	1.4	1.1	1.0	1.2	1.3	15.6	14.4	12.6
Pharmaceuticals	5,043	3,530	70.5	(44.5)	83.2	24.6	44.3	24.2	17.1	20.0	11.8	7.1	3.3	2.0	1.5	2.1	29.0	7.4	8.2
Property	20,914	3,137	284.0	13.9	10.5	11.9	10.4	9.4	10.3	8.8	7.2	4.5	3.3	2.6	1.0	1.3	38.0	31.7	27.4
Technology	62,736	32,665	19.3	22.9	17.1	18.4	15.0	12.8	13.4	10.5	8.4	5.7	4.5	3.7	1.8	2.0	31.2	30.3	28.7
Telecom	57,743	20,210	71.6	24.8	21.2	19.7	15.8	13.0	12.4	9.6	7.6	4.8	3.7	2.9	0.2	0.4	24.5	23.6	22.3
Utilities	46,027	12,999	7.3	7.9	8.6	21.3	19.8	18.2	12.9	14.1	15.0	2.7	2.4	2.3	1.7	1.8	12.6	12.4	12.5
BSE-30	495,315	239,649	25.1	15.1	22.5	17.0	14.8	12.0	9.7	8.3	6.9	3.2	2.6	2.2	1.4	1.5	19.0	17.9	18.7
BSE-30 ex-Energy	373,745	193,963	30.4	11.6	15.5	17.7	15.9	13.7	11.1	9.7	8.6	3.5	2.8	2.4	1.3	1.4	19.6	17.9	17.6
BSE-30 ex-Energy, Com.	343,459	174,072	37.8	12.2	19.3	19.6	17.4	14.6	13.2	11.2	9.5	3.9	3.2	2.7	1.3	1.4	20.2	18.6	18.6

Note:

(a) EV/EBITDA excludes Banking sector.

Source: Company, Bloomberg, Kotak Institutional Equities estimates

Banking**FED.BO, Rs209**

Rating	BUY
Sector coverage view	Neutral
Target Price (Rs)	275
52W High -Low (Rs)	407 - 162
Market Cap (Rs bn)	35.7

Financials

March y/e	2008	2009E	2010E
Sales (Rs bn)	12.8	14.8	18.1
Net Profit (Rs bn)	3.7	3.2	5.5
EPS (Rs)	34.4	18.5	32.3
EPS gth	0.5	(46.2)	74.7
P/E (x)	6.1	11.3	6.5
P/B (x)	0.9	0.9	0.8
Div yield (%)	1.9	1.6	2.9

Shareholding, March 2008

	% of Pattern Portfolio	Over/(under) weight
Promoters	-	-
FIs	52.5	0.3
MFs	13.1	0.3
UTI	-	(0.1)
LIC	2.4	(0.0)

Federal Bank : PAT exceeds estimates, maintain BUY given attractive valuation

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- **Federal Bank reported PAT of Rs681 mn in 1QFY08—marginal growth of 2% yoy and 2X our estimates**
- **Operational performance remains impressive while higher loan growth and increase in NPLs are cause for concern**
- **Retain BUY rating with a price target of Rs275**

Federal Bank reported PAT of Rs681 mn in 1QFY08—marginal growth of 2% yoy and 2X our estimates. The prime reasons for the difference between our estimates and reported profits of the company are (1) higher-than-expected NII growth and non-interest income (ex-treasury) growth, (2) lower-than-expected effective tax rate of 16% vis-a-vis our estimate of 25%. The company continues to maintain a rather high loan growth of 38% yoy, which is much higher than industry and could result in higher credit provision costs and margin pressure over a period of time. The company's gross NPLs increased by 17% sequentially to Rs5.5 bn, which according to the company, was largely due to slippage in one large account and is expected to revert back as a performing asset during the rest of the year. We have updated our estimates for the results marginally, by 1% and 3%, over the next two years. The rationale for our conservatism despite the company significantly outperforming our quarterly estimates is that a large part of income in 1QFY09 was driven by loan growth—we expect this to moderate during the course of the year and thereby lead to lower revenues in remainder of the year. We retain our BUY with target price of Rs275 given the valuation of 11.3X PER and 0.9X PBR FY2009.

NII growth was impressive at 46% yoy

- Federal Bank NII (adj. for investment amortization) grew 46% yoy in 1QFY09 to Rs2.8 bn, which was marginally higher than our estimates by 13%.
- The company's NII was aided by the rights offering of Rs21.4 bn made in January 2008, which likely enabled the company to improve its NIM to 3.85% in 1QFY09 compared to 3.76% reported in 4QFY08 and 3.2% in 1QFY08. Adjusted for the equity funds, the spreads were likely lower on a sequential basis.
- Deposit growth of the company increased sharply by 29% yoy, while advances growth was a higher 38% yoy. The incremental growth in deposits in the current quarter was Rs10 bn, while advances increased by Rs14 bn, implying that there was a run down of investments by around Rs5 bn. CASA ratio of the company remained steady at 25% in line with the historical trend.
- Significant equity raising by the company in January helped boost Tier I capital ratio to 17.8%, providing it with sufficient cushion to grow its asset book.

Non-interest income was boosted by strong fee income growth

- Non-interest income of Federal Bank in 1QFY09 was Rs962 mn – a decline of 8% yoy. While the growth in non-interest income (ex-treasury) was higher at 26% yoy. A large part of the growth in non-interest income can be attributed to the significant contribution of fee and forex income. The fee and commission income in 1QFY09 was Rs300 mn (33% of non-interest income) in 1QFY09 compared to Rs190 mn in 1QFY08, while the foreign exchange income was Rs110 mn compared to Rs90 mn in 1QFY09.
- The growth in non-interest income was also impacted by the lower recoveries booked by the company on the written-off assets. Income from recoveries of written-off assets was Rs230 mn in 1QFY09 compared to Rs470 mn in 1QFY08.

Provision burden has increased sharply in the current quarter

- Federal Bank has reported provisions (incl. investment amortization) of Rs1.8 bn, a growth of 149% yoy and 10% ahead of our estimates.
- Investment depreciation expenses were the highest contributors for the provision burden in the current quarter. The company had investment depreciation expenses of Rs1.3 bn. It is likely that a large part of the mark-to-market losses were on account of government securities, the company has a duration of four years on its Gsec portfolio.
- We note that the company has a policy of maintaining an investment fluctuation reserve at 5% of overall PAT, as a reserve against sharp changes in value of its investment book. The company had an investment fluctuation reserve of Rs1.9 bn as of June 2008.
- NPL provisions (included standard assets) for the company remained moderate at Rs320 mn in 1QFY09. The lower NPL provisions were despite the increase in gross NPLs on a sequential basis of Rs0.8 bn (17% sequential growth). The lower NPL provisions compared to the increase in gross NPLs resulted in an increase in net NPLs to Rs938 mn (1.2X of March 2008 levels).
- Asset quality remains reasonably healthy with a net NPL ratio of 0.5% and a provision coverage ratio of 83% as of June 2008.

Federal Bank, quarterly results (Rs mn)

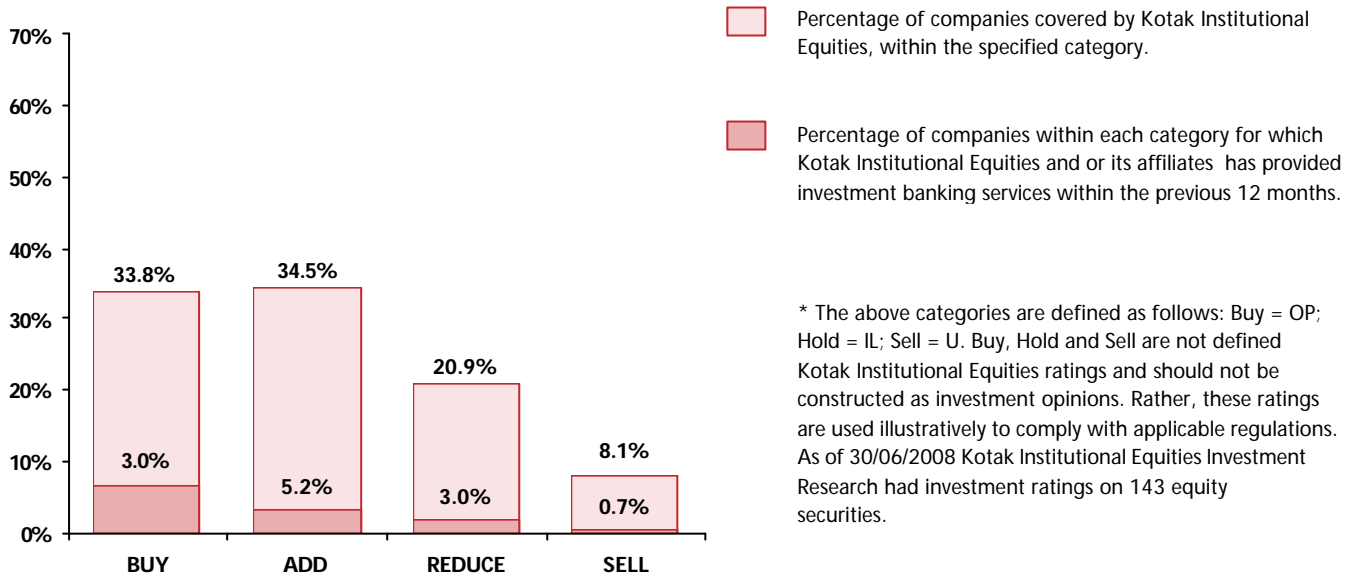
	1QFY08	2QFY08	3QFY08	4QFY08	1QFY09	% chg	1QFY09KS	Actual Vs Kotak
Interest earned	5,592	5,982	6,527	7,212	7,491	34		
Interest/discount on advances/bills	4,046	4,275	4,759	5,194	5,500	36		
Income on Investments	1,374	1,524	1,637	1,841	1,848	34		
Interest on balances with RBI and other inter bank funds	118	93	130	33	67	(44)		
Others	54	90	0	144	77	42		
Interest expended	3,665	3,918	4,450	4,442	4,669	27	2,233	3
Net interest income	1,928	2,063	2,077	2,770	2,822	46	2,500	13
Other Income	1,045	809	850	1,249	962	(8)	668	44
Sale of investments	220	130	180	200	(80)	(136)	-	(100)
Recovery of written off assets	470	120	140	280	230	(51)	-	-
Other income excl treasury	825	679	670	1,049	1,042	26	668	56
Total income	2,972	2,872	2,927	4,019	3,784	27	3,168	19
Operating Expenses	1,048	1,066	1,210	1,365	1,209	15	1,250	(3)
Payments to and provisions for employees	631	629	716	737	661	5	750	(12)
Other operating expenses	417	437	494	628	548	31	500	10
Operating profit	1,924	1,806	1,716	2,654	2,575	34	1,918	34
Other Provisions and Contingencies	710	588	385	1,417	1,764	148	1,616	9
NPL	420	670	441	700	320	(24)	400	(20)
PBT	1,214	1,218	1,331	1,238	811	(33)	302	168
Provision for Taxes	545	265	302	209	130	(76)	76	72
Net Profit	669	953	1,029	1,028	681	2	227	201
Tax rate (%)	45	22	23	17	16		25	
PBT before provisions	1,924	1,806	1,716	2,654	2,575	34	1,918	34
Key balance sheet items (Rs bn)								
Deposits	209	241	233	259	269	29		
CASA ratio (%)	25.0	25.0	25.8	25.0	25.0			
Advances	147	162	175	189	203	38		
Retail	43.5	48.6	51.7	56.1	59.4	36.6		
Retail advances to total advances (%)	NA	30.0	29.6	29.7	29.3			
Investments	74	-	81	100	95	28		
Asset management details								
Gross Non-performing assets (Rs mn)	4,408	4,729	4,948	4,686	5,484	24		
Gross NPL ratio (%)	2.9	2.9	2.8	2.4	2.6			
Net Non-performing assets (Rs mn)	542	698	514	432	938	73		
Net NPL ratio (%)	0.4	0.4	0.3	0.2	0.5			
Yield management measures (%)								
Yield on advances	11.36	11.47	11.52	11.46	11.37			
Cost of deposits	6.51	6.63	6.75	6.42	6.72			
NIM	3.21	3.15	3.17	3.76	3.85			
Capital Adequacy details (%)								
Capital Adequacy ratio	13.3	13.1	13.1	22.5	20.7			
Tier I	9.32	9.2	9.38	19.09	17.84			

Source: Company

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Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities.

As of June 30, 2008

Ratings and other definitions/identifiers

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 Sensex by more than 10% over the next 12 months.

Our target price are also on 12-month horizon basis.

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